United States Court of Appeals for the Second Circuit



APPELLANT'S BRIEF

ORIGINA75-1004

To be argued by John S. Martin, Jr.

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 75-1004

UNITED STATES OF AMERICA,

Appellee,

v.

ANTHONY M. NATELLI, and JOSEPH SCANSAROLI,

Defendants-Appellants.

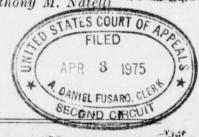
BRIEF OF DEFENDANT-APPELLANT, ANTHONY M. NATELLI

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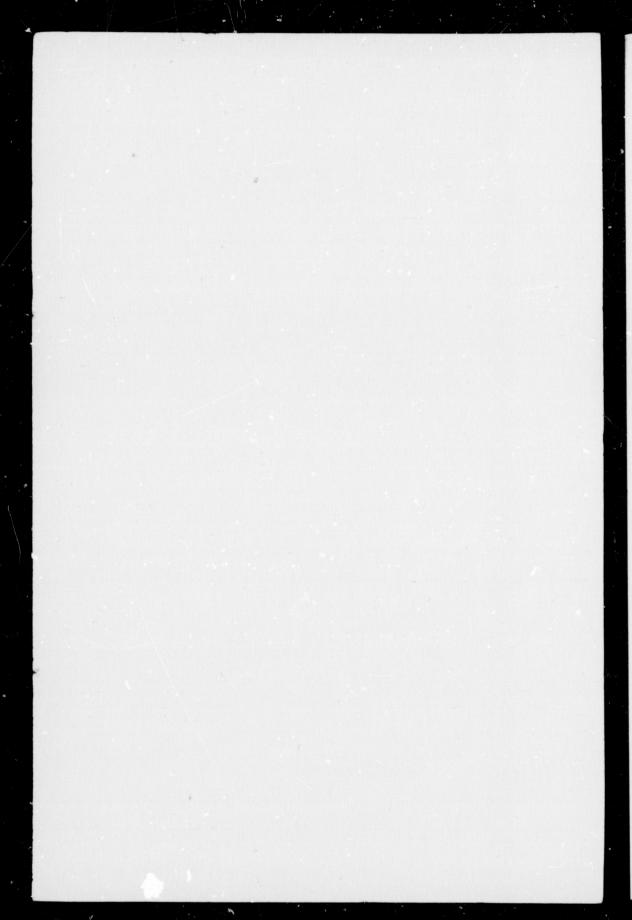


TABLE OF CONTENTS

| | PAGE |
|---|------|
| Preliminary Statement | 1 |
| Questions Presented | 3 |
| Statutes Involved | 5 |
| Statement of the Case | 6 |
| A. Events Prior to the Engagement of PMM | 6 |
| B. PMM's Examination of NSMC's Financial Statements for the Year Ended August 31, 1968 | 8 |
| C. The Events Between the Examination as at August 31, 1968 and the Preparation of the Proxy Statement in August 1969 | 13 |
| D. The Preparation of the Proxy Statement in August 1969 and the Statements Alleged to Be Materially False | 22 |
| 1. The Footnote to the Audited Statement of Earnings | 23 |
| 2. The Inclusion of the Eastern Contract in the Unaudited Nine-Month Statement of Earnings | 27 |
| 3. The Inclusion in the Unaudited Figures of the Commitments Questioned by Oberlander | 30 |
| E. The Events Subsequent to the Preparation of the Proxy Statement | 30 |
| Summary of Argument | 35 |

| P | AGE |
|--|-----|
| POINT I—THE EVIDENCE WAS NOT SUFFICIENT TO ESTAB- LISH THAT MR. NATELLI KNOWINGLY ASSISTED IN THE FILING OF A FALSE PROXY STATEMENT WITH THE SECURITIES AND EXCHANGE COMMISSION, OR EVEN THAT THE PROXY STATEMENT WAS MATERIALLY FALSE | |
| IN THE RESPECTS ALLEGED | 38 |
| A. There was No Evidence That Mr. Natelli Knowingly Made Materially False Statements | 39 |
| B. The Government Failed To Prove That The Proxy Statement Was Materially False In The Respects Alleged | 42 |
| 1. The Absence of Footnote Disclosure of the Michaels Write-offs Was Not Material | 42 |
| 2. The Government Failed To Prove That The \$813,000 of Sales For The Period Ending May 31, 1969 Were In Fact Fraudulent As Charged In The Indictment Or That Appel- lant Knew Of Any Such Fraud | 47 |
| a. The Eastern Contract | 47 |
| b. The Commitments Questioned by Oberlander | 50 |
| POINT II—THE TRIAL COURT ERRONEOUSLY INSTRUCTED THE JURY ON THE ISSUE OF KNOWLEDGE AND ON OTHER CRITICAL FACTUAL AND LEGAL ISSUES | 50 |
| A. The Court Gave An Unwarranted And Improper Charge On "Reckless Disregard" Which Confused The Jury On The Critical Issue of Knowledge and Intent | 51 |
| B. The Court Failed to Explain the Differences In an Outside Auditor's Responsibility for Audited and Unaudited Financial Statements | 58 |

| | PAGE |
|---|------|
| C. The Court Refused to Correct Vitally Important Misstatements in the Charge Concerning the Eastern Contract and Failed to Respond Properly to a Note From the Jury Indicating that They Had Been Completely Misled by These Misstatements | 61 |
| D. The Court Erroneously Charged the Jury that in Determining Whether the Audited State- ments Were Materially False, They Should Consider the Footnote Alone | 64 |
| E. The Court Erred In Not Instructing The Jury That It Must Find That Defendants Knew That The Alleged Misstatements Were Mate- rial | 67 |
| F. The Court Failed to Charge the Jury that They Must Be Unanimous As To The Particu- lar Specification of Falsity | 72 |
| G. The Court Gave A Charge On A Theory Of Motive Not Supported By The Evidence Or Even Argued By The Government | 73 |
| POINT III—EVIDENCE OF A GOOD FAITH ERROR IN COM- PUTING THE DEFERRED TAX CREDIT WAS IMPROPERLY RECEIVED AS PROOF OF FRAUD | 75 |
| POINT IV—POLYGRAPH TESTIMONY SHOULD HAVE BEEN RECEIVED ON THE ISSUE OF LACK OF KNOWLEDGE AND WILLFULNESS | 80 |
| Point V—Under the circumstances of this case, the Court should order dismissal of the indictment as a sanction for the deliberate misconduct of a senior government official involved in this prosecution | 84 |
| IN LILLS LICEDIOULIUM | |

| | PAGE |
|--|---------|
| POINT VI—THE DISTRICT COURT ERRED IN DENYING THE DEFENDANT'S MOTION TO DISMISS COUNT II OF THE INDICTMENT FOR LACK OF PROPER VENUE | 91 |
| Conclusion | 97 |
| Table of Authorities | |
| Cases: | |
| Andres v. United States, 330 U.S. 740 (1948) | 72 |
| Bentel v. United States, 13 F.2d 327 (2d Cir.), cert. denied sub nom. Amos v. United States, 273 U.S. 913 (1926) | 54, 56 |
| Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973) | 09 |
| Commonwealth v. A. Juvenile (No. 1), 15 Crim.L.Rep. 2323 (Mass.Sup.Jud.Ct. June 12, 1974) | 85 |
| Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970) | 45, 65 |
| Escott v. BarChris Construction Corp., 283 F.Supp 643 (S.D.N.Y. 1968) | |
| Estes v. Texas, 381 U.S. 532 (1965) | . 89 |
| Ex Parte Bain, 121 U.S. 1 (1886) | |
| Fischer v. Kletz, 266 F.Supp. 180 (S.D.N.Y. 1967) | |
| Frye v. United States, 293 Fed. 1013 (D.C.Cir. 1923). | .80, 81 |
| Gates v. United States, 122 F.2d 571 (10th Cir. 1941 | |
| General Time Corp. v. Talley Industries, Inc., 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 102 (1969) | d 6 |

| PAGE |
|--|
| Giglio v. United States, 405 U.S. 150 (1972) |
| Gold v. DCL , $Inc.$ [1973 Transfer Binder], CCH Fed. Sec.L.Rptr. ¶ 94,036 |
| Imperial Meat Co. v. United States, 316 F.2d 435 (10th Cir.), cert. denied, 375 U.S. 820 (1963) 96 |
| Irvin v. Dowd, 366 U.S. 717 (1961) |
| Leary v. United States, 395 U.S. 35 (1969)97, 98 |
| Marshall v. United States, 360 U.S. 310 (1959) 89 |
| Mittendorf v. J. R. Williston & Beane, Inc., 372 F. Supp. 821 (S.D.N.Y. 1974) |
| Morissette v. United States, 342 U.S. 246 (1952) 36, 39, 51, 53, 57 |
| Newton v. United States, 162 F.2d 795 (4th Cir. 1947), cert. denied, 333 U.S. 848 (1948) 96 |
| People v. Cutter, 12 Crim.L.Rep. 2133 (Sup.Ct. Cal. November 6, 1972), appeal abandoned by Dist. Atty., 14 Crim. L.Rep. (February 27, 1974) 83 |
| Quercia v. United States, 289 U.S. 466 (1933) 74 |
| Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540 (2d Cir. 1973), cert. denied, 415 U.S. 918 (1974) |
| Richland v. Crandall, 262 F.Supp. 538 (S.D.N.Y. 1967) 65 |
| Russell v. United States, 369 U.S. 749 (1962) 79 |
| SEC v. National Student Marketing Corporation (D.D.C. Civ. No. 225-72) |
| SEC v. Texas Gulf Sulphur Co., 401 F.2à 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) |
| Seeburg—Commonwealth United Litigation [72-73 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 93,802 (S.D.N.Y. 1972) |

| PAGE |
|---|
| Sheppard v. Maxwell, 384 U.S. 33 (1966)87, 89, 107 |
| State v. Alterete, 15 Crim.L.Rep. 2028 (N.Mex.Ct.App. February 27, 1974) 83 |
| State v. Stanislawski, 15 Crim.L.Rep. 2093 (Wis.Sup. Ct. April 4, 1974) 83 |
| Stirone v. United States, 361 U.S. 212 (1960) 79 |
| Travis v. United States, 364 U.S. 631 (1961)94, 95 |
| Travis v. United States, 247 F.2d 130 (10th Cir. 1957) 94 |
| United States v. Abrams, 427 F.2d 86 (2d Cir.), cert. denied, 400 U.S. 832 (1970)54, 56, 57 |
| United States v. Adcock, 447 F.2d 1337 (2d Cir.), cert. denied, 404 U.S. 939 (1971)37, 48, 72, 98 |
| United States v. Archer, 355 F.Supp. 981 (S.D.N.Y. 1972), rev'd on other grounds, 486 F.2d 670 (2d Cir. 1973) |
| United States v. Benjamin, 328 F.2d 854 (2d Cir.), cert. denied sub nom. Howard v. United States, 377 U.S. 953 (1964) |
| United States v. Bozza, 365 F.2d 206 (2d Cir. 1966) 96, 97 |
| United States v. Brawer, 482 F.2d 117 (2d Cir. 1973) 56, 57 |
| United States v. Brettholz, 485 F.2d 483 (2d Cir. 1973), cert. denied, 415 U.S. 976 (1974) |
| United States v. Bryant, 439 F.2d 642 (D.C. Cir. 1971) 88 |
| United States v. Byrd, 352 F.2d 570 (2d Cir. 1965) 79, 97 |
| United States v. Casale Car Leasing, Inc., 385 F.2d 707 (2d Cir. 1967) |
| United States v. Cashin, 281 F.2d 689 (2d Cir. 1960) 92 |
| United States v. Chastain, 435 F.2d 686 (7th Cir. 1970) 83 |

| n.o. | |
|---|----|
| PAGE | E |
| United States v. Cirillo, 468 F.2d 1233 (2d Cir. 1972), cert. denied, 410 U.S. 984 (1973) | 0 |
| United States v. Clemons, 503 F.2d 486 (9th Cir. 1974) 79 | 9 |
| United States v. Crosby, 294 F.2d 928 (2d Cir. 1961), cert. denied sub nom. Mittleman v. United States, 368 U.S. 984 (1962) | 4 |
| United States v. DeAngelis, 490 F.2d 1004 (2d Cir.), cert. denied, 94 S.Ct. 1970 (1974) | 3 |
| United States v. DeBetham, 470 F.2d 1367 (9th Cir. 1972) | 5 |
| United States v. Deutsch, 475 F.2d 55 (5th Cir. 1973) 8 | 8 |
| United States v. Diogo, 320 F.2d 898 (2d Cir. 1963) 4 | 8 |
| United States v. Fernandez, 480 F.2d 726 (2d Cir. 1973) | 4 |
| United States v. Ferrara, 451 F.2d 91 (2d Cir. 1971), cert. denied, 405 U.S. 1032 (1975) 5 | 8 |
| United States v. Fields, 466 F.2d 119 (2d Cir. 1972) 5 | 57 |
| United States v. Francis, 487 F.2d 968 (5th Cir. 1973), cert. denied, 94 S.Ct. 1615 (1974) | 33 |
| United States v. Frogge, 476 F.2d 969 (5th Cir. 1973), cert. denied, 414 U.S. 849 (1974) | 34 |
| United States v. Garguilo, 310 F.2d 249 (2d Cir. 1962) | 75 |
| United States v. Gillette, 189 F.2d 449 (2d Cir.), cert. denied, 342 U.S. 827 (1951) | 97 |
| United States v. Gottlieb, 493 F.2d 987 (2d Cir. 1974) 5 | 54 |
| United States v. Grassia, 354 F.2d 27 (2d Cir. 1965), vacated on other grounds, 390 U.S. 202 (1968) 8 | 39 |
| United States v. Greisa, 481 F.2d 276 (2d Cir. 1973) | 93 |

| I | PAGE |
|--|-------|
| United States v. Gross, 276 F.2d 816 (2d Cir.), cert. denied, 363 U.S. 831 (1960) | 3, 97 |
| United States v. Grunberger, 431 F.2d 1062 (2d Cir. 1970) | 75 |
| United States v. Guglielmini, 384 F.2d 602 (2d Cir. 1967), cert. denied, 400 U.S. 820 (1970) | 63 |
| United States v. Hong Loi Cheng, 350 F.Supp. 67 (S.D.N.Y. 1972) | 89 |
| United States v. Hughes, 195 F.Supp. 795 (S.D.N.Y. 1961) | 92 |
| United States v. Infanti, 474 F.2d 522 (2d Cir. 1973) | 49 |
| United States v. Jacobson, 325 F.2d 409 (2d Cir. 1963), aff'd, 380 U.S. 246 (1965) | 98 |
| United States v. Jones, 174 F.2d 746 (7th Cir. 1949) | 97 |
| United States v. Lanza, 356 F.Supp. 27 (M.D.Fla. 1972) | 83 |
| United States v. McCord, — F.2d — (D.C. Cir. No. 73-2252) (December 12, 1974) | 89 |
| United States v. Miller, 246 F.2d 486 (2d Cir.), cert. denied, 355 U.S. 905 (1957) | 96 |
| United States v. Mitchell, 372 F.Supp. 1239 (S.D.N.Y. 1973) | 89 |
| United States v. Monjar, 47 F.Supp. 421 (D.Del. 1942), aff'd, 147 F.2d 916 (3rd Cir.), cert. denied, 325 U.S. 859 (1945) | 92 |
| United States v. O'Connor, 237 F.2d 466 (2d Cir. 1956) | 63 |
| United States v. Olivares-Vega, 495 F.2d 827 (2d Cir. | 58 |

| PA | AGE |
|--|------|
| United States v. Ottley, 2d Cir. Docket No. 74-1731, decided January 7, 1975 | 58 |
| United States v. Pacheco, 489 F.2d 554 (5th Cir. 1974), U.S. App. Pndg. 43 U.S.L.W. 3039 (U.S. Apr. 13, 1974 | 83 |
| United States v Peltz, 433 F.2d 48 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971)53, | , 54 |
| United States v. Pope, 189 F.Supp. 12 (S.D.N.Y. 1960) | , 93 |
| United States v. Provoo, 215 F.2d 531 (2d Cir. 1954) | 97 |
| United States v. Ridling, 350 F.Supp. 90 (E.D. Mich. 1972) | , 83 |
| United States v. Ruehrup, 332 F.2d 641 (7th Cir.), cert. denied, 379 U.S. 904 (1964) | 96 |
| United States v. Sarantos, 455 F.2d 877 (2d Cir. 1972) | 54 |
| United States v. Silverman, 248 F.2d 671 (2d Cir. 1957), cert. denied, 355 U.S. 942 (1958) | 98 |
| United States v. Simon, 425 F.2d 796 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970)38, 40, 45, 53, 65 | |
| United States v. Slutsky, 487 F.2d 832 (2d Cir. 1973), cert. denied, 94 S.Ct. 1937 (1974) | 96 |
| United States v. Smith, 230 F.2d 935 (6th Cir. 1956) | 66 |
| United States v. Spica, 413 F.2d 129 (8th Cir. 1969) | 79 |
| United States v. Squires, 440 F.2d 859 (2d Cir. 1971) | , 57 |
| United States v. Stifel, 437 F.2d 431 (1970), cert. denied, 401 U.S. 994 (1971) | 84 |

| | PAGE |
|---|--------|
| United States v. Stromberg, 179 F.Supp. 278 (S.D. N.Y. 1959) | 81 |
| United States v. Sweig, 316 F.Supp. 1148 (S.D.N.Y. 1970), aff'd. 44 F.2d 114 (2d Cir.), cert. denied, 403 U.S. 932 (1971) | 4, 96 |
| United States v. Taller, 394 F.2d 435 (2d Cir.), cert. denied, 393 U.S. 839 (1968) | 97 |
| United States v. Travers, 2d Cir. Docket No. 74-1737, decided November 16, 1974 | 48 |
| United States v. Tremont, 351 F.2d 144 (6th Cir. 1965) | 83 |
| United States v. Wainwright, 413 F.2d 796 (10th Cir. 1969), cert. denied, 396 U.S. 1009 (1970) | 83 |
| United States v. Walden, 464 F.2d 1015 (4th Cir. 1972) | 4, 96 |
| United States v. Williams, 424 F.2d 353 (5th Cir. 1970) | 92 |
| United States v. Zeiger, 350 F.Supp. 685 (D.D.C.), rev'd per curiam, 475 F.2d 1280 (D.C. Cir. 1972), cert. denied, 412 U.S. 907 | 31, 82 |
| United States ex rel. Sadowy v. Fay, 284 F.2d 426 (2d Cir.), cert. denied, 365 U.S. 850 (1960) | 81 |
| Walther v. O'Connell, 72 Misc.2d 316, 339 N.Y.S.2d 386 (Civ.Ct. Queens 1972) | 83 |
| Yates v. United States, 354 U.S. 298 (1957) | 98 |
| Constitution, Statutes, Rules and Regulations | |
| 15 U.S.C. 77(a) | 92 |
| Securities Exchange Act of 1934, Section 14a, 15 U.S.C. § 78n(a) | 95 |

| PAGE |
|---|
| Securities Exchange Act of 1934, Section 23(a), 15 U.S.C. § 78w(a) |
| Securities Exchange Act of 1934, Section 27, 15 U.S.C. § 78aa 5,91 |
| *Securities Exchange Act of 1934, Section 32(a), 15 U.S.C. § 78ff |
| 15 U.S.C. § 781, 78m |
| 23 D.C. Code § 104(d), (e) |
| 17 C.F.R. § 200.22 |
| 18 U.S.C. 1001 |
| 17 C.F.R. § 210.3-02, Reg. S-X Rule 3-0267, 70 |
| 18 U.S.C. § 1341 |
| 18 U.S.C. § 323792, 94, 96 |
| 28 C.F.R. § 50.2(b) |
| 28 U.S.C. 2106 |
| Local Rule 8, Rules of the United States District Court for the Southern District of New York ("Free Press—Fair Trial Directives") |
| Federal Rules of Evidence, Rule 702 84 |
| Miscellaneous |
| American Bar Association Code of Professional Responsibility, Disciplinary Rule 7-107(B)(6)(1971) 87 |
| American Bar Association Project on Standards for Criminal Justice, "Standards Relating to Fair Trial and Free Press, §1.1(b)" (1968) |
| AICPA, Statement on Auditing Standards No. 1 § 516.02 |

| | PAGE |
|--|---------------|
| AICPA, Statement on Auditing Standards No. 1 § 516.06 | 49 |
| AICPA, Auditing Standards and Procedures—Statements on Auditing Procedure No. 33 (1963) | 70 |
| APB, Accounting Principles § 510.09 (1968) | 70 |
| Inbau & Reid, Lie Detection and Criminal Interrogation (3d ed. 1953) | 84 |
| Memorandum to the Heads of All Executive Departments, Agencies and Independent Establishments Re Press Releases and Other Public Statements Concerning Litigation Being Conducted by the Department of Justice, September 17, 1974 | 3 |
| Reid & Inbau, Truth and Deception: The Polygraph ('Lie Detector') Technique (1966) | 84 |
| Note, The Emergence of the Polygraph at Trial, 73 Colum.L.Rev. 1120 (1973) | |
| Note, Pinnochio's New Nose, 48 N.Y.U.L.Rev. 339 (1973) | 9 . 83, 84 |
| Wicker, The Polygraph Truth Test and the Law o Evidence, 22 Tenn.L.Rev. 711 (1953) | f . 84 |

Preliminary Statement

Anthony M. Natelli and his co-appellant Joseph Scansaroli appeal from judgments of conviction entered in the United States District Court for the Southern District of New York on December 27, 1974 after a four-week trial before Hon. Harold R. Tyler and a jury. Judge Tyler imposed a one-year sentence and a \$10,000 fine upon Mr. Natelli, suspending all but 60 days of the imprisonment, and a one-year sentence and a \$2,500 fine upon Mr. Scansaroli, suspending all but 10 days of the imprisonment.

At the time of the material events, Mr. Natelli, a certified public accountant, was the partner in charge of the Washington, D. C. office of Peat, Marwick, Mitchell & Co. ("PMM") and the engagement partner in respect of PMM's audit engagement for National Student Marketing Corporation ("NSMC"), and Mr. Scansaroli, a certified public accountant, was an employee of PMM, assigned as audit supervisor on that engagement.

One count of a multi-count indictment* charged that, in violation of Section 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff, four of the NSMC officers and Mr. Natelli and Mr. Scansaroli, as independent auditors, "wilfully and knowingly made and caused to be made false and misleading statements with respect to material facts" in a proxy statement for NSMC dated September 27, 1969 which was required to be and was filed with the SEC.

The 270-page printed proxy statement was issued by NSMC in connection with a special meeting of its stockholders called to consider a charter amendment increasing its authorized capital stock, an employees' stock option

^{*}The multi-count indictment also charged five officers of NSMC and three unindicted co-conspirators with conspiracy to defraud and substantive violations of the mail fraud and securities statutes. Prior to trial, four of the indicted NSMC officers pleaded guilty to various counts, and the trial of the fifth was severed.

plan and the mergers of six companies, including Interstate National Corporation ("Interstate"), into NSMC. The false and misleading statements specified in the indictment related to two aspects of the consolidated summary of earnings of NSMC and footnotes thereto which appeared at pages 21-23 of the proxy statement (E. 167-169):

- (1) In the first nine months of fiscal 1969, NSMC had acquired by merger a number of companies whose sales and earnings were, as was required, retroactively pooled with the sales and earnings of NSMC for 1968 and earlier years. Principally as a result of the poolings, NSMC which in its original report for the year ended August 31, 1968 showed sales and earnings of \$4,989,446 and \$388,031, respectively, was reporting for the same period in the proxy statement sales and earnings of \$11,541,895 and \$773,152. Footnote (D) to the audited financial statements, which was designed to show the effect of the poolings on earnings trends by reconciling the sales and earnings previously 1eported for fiscal years 1966, 1967 and 1968 with the sales and earnings for those years stated in the proxy statement, was alleged to be materially misleading in that it failed to disclose the later write-off of \$748,762 of sales previously accrued by NSMC for 1968. After taking into account the elimination of accrued costs of \$539,012 on those sales and a \$188,750 over-accrual in 1968 for taxes, the net change was a reduction of \$21,000 out of previously reported earnings for 1968 of \$388,031. The issue was whether the nondisclosure was material and, if so, whether Mr. Natelli knew that it was material, given the significance he attributed to the changes in NSMC's business in 1969, the termination by NSMC of the employee who had been responsible for the written-off sales and the minimal effect of the adjustments on the "bottom line" earnings.
 - (2) The unaudited summary of earnings contained sales and earnings for the nine months ended May 31, 1969 of

\$11,313,569 and \$702,270, respectively. In accordance with the accounting method followed by NSMC in respect of fixed-fee arrangements, which was described in footnote (B) to the summary of earnings, NSMC accrued sales income upon obtaining a written commitment from its clients to participate in the programs it offered. The indictment alleged that Mr. Natelli knew that approximately \$813,000 of such sales included in those figures were fraudulent, the principal item being a \$519,000 commitment from Eastern Airlines to purchase services from NSMC, evidenced by an apparently binding letter signed by Thomas E. Mullen, an Eastern Airlines executive. The commitment was characterized on summation by counsel for the Government, without any evidentiary support, as a "complete phony" (Tr. 2295). The issues were whether the commitment was fraudulent (if such can be said to be an issue in the absence of evidence) and, if so, whether Mr. Natelli knew it to be fraudulent.

These issues have been stated in terms of knowledge which is what the statute requires and the indictment pleaded. Yet, as a result of a combination of errors, a guilty verdict was returned despite the fact that the proof failed to establish that appellant acted with the culpable state of mind which the statutory terms "willfully and knowingly" embody. At sentencing, the judge told appellant:

"I think you are absolutely sincere when you say that you do not believe that you did anything wrong in this audit or audits for National Student Marketing." (A. 284).

Questions Presented

1. Whether a conviction for "willfully and knowingly" filing a false statement may stand where the evidence failed to establish that the defendant actually knew

the statements were materially false or even that the statements were, in fact, false in the respects alleged?

- 2. Whether a conviction for "willfully and knowingly" filing a false statement may stand where the charge of the court
 - A. Contained an instruction on the concept of "reckless disregard" which was unwarranted by the facts of the case and erroneous in that it permitted a conviction on a finding of some aggravated level of negligence;
 - B. Led the jury to believe that an accountant has the same duty with respect to a company's unatited statements as he has when he is performing an audit:
 - C. Misstated the undisputed evidence on one of the central factual issues, and the court thereafter improperly responded to a note indicating that the jury had been misled by the court's statement;
 - D. Erroneously advised the jury that in determining materiality a single footnote should be considered alone and not in the context of the financial statements as a whole;
 - E. Failed to make clear to the jury that conviction required not only a finding of objective materiality but also that the defendant knew the alleged mistatements to be material:
 - F. Failed to advise the jury that they must be unanimous as to one of the two respects in which the indictment alleged the proxy was false;
 - G. Advised the jury on a theory of motive not argued by the Government and not supported by any evidence?
 - 3. Whether evidence of an error in resolving a difficult accounting issue could properly be received as evidence of fraud when the indictment did not question this item

and all available evidence indicated it was nothing more than a good faith mistake?

- 4. Whether testimony of a polygraph expert should have been received on the issue of lack of knowledge and wilfulness?
- 5. Whether the misconduct of a senior government official involved in the prosecution in deliberately expressing an opinion on the defendant's guilt in a newspaper interview published during the trial warrants dismissal of the indictment?
- 6. Whether in a prosecution for making false statements in a document required to be filed with the Securities and Exchange Commission, venue is proper only in the District of Columbia where the document must be and was filed and where the statements are made?

Statutes Involved

Section 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff(a) provides in relevant part:

(a) Any * * * or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 780 of this title, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than \$10,000, or imprisoned not more than two years, * * *

Section 27 of the Securities Exchange Act of 1934, 78 U.S.C. § 78aa provides in relevant part:

* * Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. * *

Statement of the Case

The trial of this case occurred in the fall of 1974, some five to six years after the events at issue.* As a result, the recollections of witnesses, both Government and defense, were understandably vague in certain respects, with testimony concerning lengthy meetings often covering but a few lines of the trial transcript. The following statement of facts, like the trial itself, cannot possibly place the events which this trial highlighted into the context of the real lives of the two men whose convictions are before the Court.

A. Events Prior to the Engagement of PMM

National Student Marketing Corporation was founded in 1966 by Cortes Randell. It provided to major corporate accounts a diversified range of advertising, promotional and marketing services designed to reach the youth market. Through a system of student representatives on campuses throughout the country, NSMC offered its clients the opportunity to place advertising posters on campuses and to distribute samples and other promotional material to students. NSMC also published campus photo directories, university telephone directories and other items of use to students, all of which contained space for advertising. In addition, through its mailing lists of students throughout the country, NSMC offered its clients programs for mailing advertising literature and product samples to students, either alone or in conjunction with other advertisers (Tr. 1813, 1818, Gx. 5).**

^{*} The SEC instituted a private investigation in early 1970 and commenced a civil injunctive action in March 1972. The indictment was not returned until 1974. This delay cannot be attributed to the defendants or the court.

^{**} References in the form "Tr." are to the stenographic transcript of the trial which appears in Volume II, III and IV of the Appendix, with the original pagination retained. References in the form "A." are to Volume I of the Appendix. References in the form "Gx." are to Government Exhibits which are found in the separate Exhibit Appendix.

In April, 1968, NSMC, which was then based in Washington, D.C., had its first and only public offering of stock. The stock was originally offered to the public at \$6.00 per share. At that time its financial statements were audited by Arthur Andersen & Co. and it was represented by the law firm of Covington & Burling.

In the summer of 1968, NSMC, which had just hired a new comptroller, Bernard Kurek, retained Michael Sullivan, an independent certified public accountant, to prepare an unaudited statement of earnings for the nine-month period ending May 31, 1968. During the course of preparing these financial statements, Sullivan had discussions with Randell and Kurek concerning the proper method of accounting for commitments to participate in various NSMC programs that had been obtained from major corporate clients. Randell explained that the major portion of NSMC's effort was expended in developing an overall marketing program for a particular client which could utilize various advertising programs offered by NSMC. These programs were then presented to the client, which decided whether it would commit to participate in the suggested programs. Once a commitment was obtained from a client, the essentially mechanical tasks of printing and mailing of the advertising material were done by outside contractors and the on-campus distribution was handled by the campus representatives. Randell explained that there was a considerable time lag between the obtaining of a commitment and the execution of a written contract, and that the major portion of NSMC's time, effort and costs was incurred well before any written contract was obtained. Randell stated that for these reasons, the company believed it appropriate to accrue income from a client's commitment to participate in one of these fixed-fee programs as of the time the commitment was made.

Sullivan concluded that given the nature of the company's business, it was appropriate for the company to accrue a substantial percentage of the total income to be received from a client at the time the client committed

to the program. Thus, Sullivan permitted the company to accrue income on the basis of written representations from NSMC's account executives that major corporations had orally committed to participate in fixed-fee programs that had been presented to them. Approximately \$260,000 of such income was accrued and included in the statement of earnings for May 31, 1968 issued by the company. That statement of earnings showed that for the nine-month period, NSMC had net earnings of \$288,390 (Tr. 469-482, Gx. Ex. 46A, Natelli Exhs. B and C).

B. PMM's Examination of NSMC's Financial Statements for the Year Ended August 31, 1968

In August, 1968, Cortes Randell contacted Larry Horner, a partner in PMM's Kansas City office, whom he had met previously, and asked him if PMM would be interested in becoming the auditors for NSMC. Since NSMC's headquarters were in Washington, D.C., Horner contacted appellant Natelli, who was the partner-in-charge of PMM's Washington office, and arranged a meeting with Randell in late August. At that meeting Randell discussed NSMC's activities and explained that he was changing auditors because the fees for services charged by NSMC's prior auditors, Arthur Andersen & Co., repeatedly exceeded the amount originally estimated. Randell assured the PMM representatives that NSMC had not had any professional disagreements with the prior auditors, and Natelli subsequently confirmed that fact with the partnerin-charge of Arthur Andersen's Washington office (Tr. 1811-1821, Natelli Exhs. S & T).

PMM agreed to audit the financial statements of NSMC for the fiscal year ended August 31, 1968, and Natelli assigned the co-appellant, Joseph Scansaroli, to serve as the supervisor on the NSMC engagement. Two other PMM employees, John Johnston and Douglas Oberlander, were assigned to work with Scansaroli (Tr. 1821-1822).

In late August, Natelli and Scansaroli met with Bernard Kurek and Bill Chapman, who explained that they had both recently joined NSMC's accounting department, and that the records of the company were a month or two behind and not in good shape. Kurek explained that in preparing the quarterly statement for the nine-month period ended May 31, 1968, the accounting department had not found out about certain contracts reported for that period until July. Natelli and Scansaroli indicated that they had been involved in other audits where the company's books were not in the best of shape (Tr. 141-143).

PMM's audit of NSMC progressed and some time in late September or early October, Randell and Kurek had a meeting with Natelli and Scansaroli at which they discussed the method of accounting NSMC had been using with respect to the fixed-fee programs. Randell explained that the company had originally offered programs to its clients involving mailings to students or the placing of posters on campuses which were designed to elicit some form of response from the students, such as the return of a coupon or order form. In such situations, NSMC had been compensated on a per inquiry basis, i.e., so many cents for each inquiry received by the client. On the other hand, during the course of the fiscal year just ended, NSMC had devoted a substantial part of its effort and expenses to developing a fixed-fee type of business in which NSMC's account executives would develop overall marketing programs for the client to reach the youth market by utilizing a combination of the mailings, posters and other advertising programs offered by NSMC. For these programs, NSMC's compensation was not tied to the number of responses received from the students, but rather, NSMC and the client agreed on a fixed-fee to be charged for participating in the various programs. Randell said that the company believed that it was proper to recognize income on these fixed-fee contracts at the time the clients committed themselves to participate in the programs presented to them by the account executives, and that this was the method of accounting used by the company in preparing the financial statements for the period ending May 31, 1968 that had been distributed to the shareholders. Although no decision was made at this meeting as to the accounting treatment to be accorded to the fixed-fee contracts, Natelli told Randell and Kurek to accumulate the necessary information (Tr. 330-331, 1494-1497, 1825-1832).

Subsequent to this meeting, Natelli and Scansaroli discussed between themselves the proper method of accounting for these contracts. They considered the possibility of deferring the costs of developing the fixed-fee type business and amortizing them over the life of the fixed-fee program, but concluded that because these costs included rent, secretarial services, travel, etc., it would be difficult to allocate such costs to particular fixed-fee contracts. Another method considered was the completed contract method, pursuant to which no income would be accrued until all the services required to be provided, including third-party services, had been completed. They also considered the suggestion that Randell had made that all of the income on the contract be recognized at the time a commitment was obtained from a client (Tr. 1497-1498, 1832-1838).

As a result of these discussions, Natelli reached a tentative conclusion that it would be appropriate to use a percentage-of-completion approach to the recognition of in-· come on these commitments, pursuant to which the company would accrue that percentage of the gross income and related costs on a client's commitment that was equal to the percentage of the time spent by the account executive on the project prior to August 31, 1968, to the total time he would have to spend to complete the project. Before a final decision would be made, however, Scansaroli was to verify the status of NSMC's client commitments. The verification process was difficult because prior to August 31, 1968, NSMC had not asked its clients to put the commitments in writing and almost all of the commitments were oral. Natelli therefore directed Scansaroli to go to NSMC's New York office where the account executives operation was headquartered to review with the account executives the commitments they had received and any documents or correspondence substantiating what had taken place. Since NSMC had not pressed its clients for written commitments. Randell

asked if it was possible to use some means other than written confirmations to confirm these commitments. Natelli, therefore, instructed Scansaroli to test the existence of these commitments by making telephone calls at random to the clients involved (Tr. 1498-1501, 1838-1839).

Subsequently, Scansaroli went to New York and spoke with various account executives, reviewed their files and made telephone calls to representatives of the major clients who had committed to participate in the fixed-fee programs. He also received a schedule prepared by Kurek showing a total of approximately \$1.7 million in commitments which NSMC had obtained, as well as a substantially complete set of forms signed by the account executives indicating the gross amount of the client's commitment, the printing and distribution costs to be incurred on the particular program, and the account executive's estimate of the percentage of completion of the program (Gx. 3, E. 10-28; Tr. 196, 1501-1505, 1508-1512).

Upon his return from New York, Scansaroli reported to Natelli on what he had done, and Natelli determined that it would be appropriate to permit NSMC to recognize income on these client commitments on a percentage-of-completion basis (Tr. 180-181, 1506-1508, 1839-1841, Ex. 5 n. 3, E. 55). In making this decision Natelli and Scansaroli recognized that the choice of the proper method of accounting for these transactions was not easy, particularly since NSMC was a young company whose records were not in the best shape. Their reasons for adopting this method were clearly set forth at the time in a memorandum in the PMM workpapers dated October 26, 1968 which Scansaroli prepared at Natelli's direction. This memorandum stated:

"This is the first full year (8/31/68) in which NSMC has had this type of operations on this scale. NSMC has been using the suggested method for the first three quarters of the year and there is no reason to discontinue this method now. It would be a lot easier if this was the 2nd or 3rd year of full scale operations. We would have proper files and statistics to work with.

However, this is the first year and we have little elternative but to follow the suggested method.

"Also, based on the going concern concept, it would appear that we should record these contracts as outlined above. If we don't record them, we would probably show a consolidated loss for the year and many stockholders would sell their stock based on one figure without reading the narrative portion of the report. Subsequently in future quarterly reports, the company would show a large profit as there are over 1½ million dollars of commitments outstanding. Many of the stockholders will probably wish they had held onto the stock and we could be criticized for not using proper accounting principles" (Gx. 3, E. 4-5).

The legitimate concern expressed in this memorandum for the effect of this accounting judgment on the public shareholders of NSMC was no doubt caused in part by the fact that NSMC's stock which was issued to the public in April 1968 at \$6 per share was already selling at \$80 per share by September 1968, before these accounting questions were presented to Natelli and Scansaroli (GX. 25, E. 158).

The financial statements for NSMC for the year ended August 31, 1968 that were issued in November reflected the accounting for the client commitments in two items, one accruing the gross amounts of the commitments, and the other accruing the costs to be incurred on those commitments. The financial statements listed "Unbilled receivable and estimated earnings on contracts in progress (Note 3)—\$1,763,992" and "Accrued costs on contracts in progress \$1,068,303".

The method of accounting used to arrive at these figures was clearly set forth in footnote 3 to the financial statements as follows:

"(3) Contracts in Progress

During the year 1968 the company's volume of business on fixed fee type arrangements increased substantially. This business involves employees of the

company developing over-all marketing and/or advertising programs for clients and/or prospective clients. The major portion of the work done by the company involves determination of the client's requirements and proposal by the company of an overall program. The eventual implementation of the agreed-upon program is carried out by representatives and third parties, generally on a fixed commission or charge per piece basis. Owing to the nature of this activity, management believes that income is best matched against costs directly connected with the production of this income by recording the estimated gross profit based on the percentage of time incurred to the total estimated time to be incurred by the emplovees in the development of the over-all program for the client. Accordingly, all such programs for which a client commitment was considered to exist as of August 31, 1968, have been accounted for on this basis. Costs related to development of programs for which no client commitment existed as of August 31. 1968, have been charged to expenses" (Gx. 5, E. 55-56).

C. The Events Between the Examination as at August 31, 1968 and the Preparation of the Proxy Statement in August 1969

The audit of the financial statements for the year ended August 31, 1968 was concluded in late November or early December, 1968. On December 9, 1968, Natelli and Scansaroli met with Randell, Kurek, John Davies, NSMC's house counsel, John Buck, a CPA who had recently been hired to work with Kurek, and several other officers of NSMC.

Natelli explained that during the course of the audit and particularly with regard to the fixed fee contracts, PMM had to deal with the situation as it existed, but that prospectively PMM viewed it as extremely important for NSMC to get much better administrative control over this area and to establish a better record-

keeping system for the fixed-fee contracts. Natelli said that the account executives should maintain logs of the time spent on various projects and submit these to the accounting department, and that periodic reports of the status of each contract should be made. Natelli also stated that from then on, NSMC should only record income on commitments if a written commitment had been obtained and that when it came time for PMM to do an audit for the fiscal year ending August 31, 1969, he intended to confirm all commitments in writing. Within a few days of this meeting, Davies, NSMC's house counsel, drafted a letter to be used by the company for future commitments which he told Natelli would be an appropriate binding contract. Natelli agreed that the letter would be satisfactory from an accounting standpoint (Tr. 206-211, 490-492, 530-532, 673, 1845-1850).

After the meeting of December 9, 1968, and through the first five months of 1969, Natelli and Scansaroli performed no significant services for NSMC. Since NSMC was involved in a substantial acquisition program, Natelli was contacted from time to time by various officials of NSMC and asked for his opinion as to various accounting problems involved in these mergers. In early March, 1969, Kurek prepared an income projection for NSMC which indicated that NSMC would suffer losses on certain of the commitments that had been recorded at August 31, 1968. Kurek recalled that this schedule was discussed with Natelli and Randell at a meeting in Natelli's office in March, and that Randell insisted that he had reports from the account executives indicating that Kurek's statements were erroneous (Tr. 219-225, 503-504, 1850-1853).

During the period from November 1968 to May 1969, NSMC had acquired a number of companies, all of which produced items or provided services of particular interest to the youth market. Sometime in April or May of 1969, Natelli and Scansaroli were advised that NSMC was planning to prepare a proxy statement to obtain authorization from its shareholders for the issuance of additional shares needed for its acquisition program. As originally planned, the proxy statement was to contain the audited financial statements for the year ended August 31, 1968 and unaudited financial statements for the six months ended February 28, 1969 (Tr. 249-250, 1885-1886).

Sometime in late April or early May, Natelli had a telephone conversation with Davies in which he was advised that Ron Michaels, a vice president of NSMC and its Director of Marketing, had been fired because the company had learned that he was taking kickbacks from certain suppliers. Natelli was further advised that after Michaels' discharge, another account executive had been assigned to the accounts which Michaels had handled personally, and he discovered that the commitments reported by Michaels had never, in fact, existed. Natelli spoke to Randell and confirmed the facts about Michaels that Davies had reported. After considering the matter, and perhaps discussing it with Scansaroli, Natelli decided that, since the Michaels commitments never existed, these contracts should be written off retroactively to August 31, 1968, because had the truth been known at that time, the contracts would not have been recorded in the first place. In making this decision, Natelli was in no way pressured by the client and, indeed, the client made no suggestion as to the accounting treatment of the Michaels contracts. Michaels contracts involved gross sales of \$748,762, on which costs of \$539,012 had been accrued. Thus, the effect of the write-off of these contracts would be to reduce 1968 income by \$209,750 (Tr. 661-664, 1853-1857).

At about the same time, Carol Raimondo, a tax specialist in PMM's Washington office, was working on NSMC's federal income tax return for the year ended August 31, 1968, which was due to be filed on May 15, 1969. Mrs. Raimondo's notes of her review of that return state:

"Note possible deferred tax liability problem. ¶44 of Opinion 11 would seem to indicate that large de-

ferred tax liability was not necessary." (Natelli Ex. O).*

Schedule M of NSMC's 1968 tax return reflected the fact that the financial statements of NSMC for the period ending August 31, 1968, had recorded a deferred tax provision for Federal and District of Columbia taxes of the parent company totalling approximately \$190,000. For tax purposes, however, the company was reporting a loss of \$613,000 (See Natelli Ex. P). Mrs. Raimondo concluded, therefore, that the carry forward of this tax less into subsequent periods would offset the taxes due on the income that had been accrued for financial statement purposes but not for tax purposes and thus, eliminate the need for the deferred tax provision of \$190,000.

After discussing the matter with Gene Holloway, her superior in the tax department, Mrs. Raimondo advised Scansaroli that in her opinion substantially all of the \$190,000 provision for deferred taxes originally accrued as of August 31, 1968, should not have been accrued (Tr. 1381-1390).

Scansaroli advised Natelli of Mrs. Raimondo's conclusion that the \$190,000 deferred taxes accrued at August 31, 1968 should not have been recorded, and Natelli spoke with Holloway, who said that he concurred with her decision. It was agreed, therefore, that an entry would have to be made writing off this deferred tax liability (Tr. 1858-1862).

During the course of the preparation of the proxy statement Natelli and Scansaroli met with Kurek and Buck and were advised that the company was writing-off in the current year some 1968 commitments, amounting to approxi-

^{*} Deferred taxes is an account normally set up on a corporation's financial statements to give recognition to the fact that the income being reported for financial statement purposes is greater than that reported for tax purposes, but that eventually a tax liability for the income being reported will arise.

mately \$212,000 of gross sales on which there had been costs of \$100,000 accrued. Kurek and Buck asked Natelli and Scansaroli for their advice as to the appropriate way to write off the Michaels contracts (Tr. 633-640). Subsequently Scansaroli gave Buck a proposed entry to retroactively write off three Michaels contracts. This entry netted that write-off against the retroactive write-off of the deferred tax provision (Tr. 642-646, 656-664).

Buck, a Government witness, testified that at the time this entry was proposed, Scansaroli told him that if they had known about Michaels' fraud, they would not have recorded those contracts originally. Scansaroli also explained that they had discovered that there had been an error in computing the original provision for deferred taxes which had to be corrected (Tr. 663-664).

Buck, who is a CPA, testified that if contracts were originally recorded in income as a result of an employee fraud, it was appropriate to write them off retroactively by making entries to retained earnings, and that to correct an error in calculating a deferred tax provision, entries also would be made to retained earnings. Buck testified further that it is permissible for accountants to combine two entries where the net effect balances out, and that the entries proposed by Scansaroli for the Michaels contracts and the tax error had the same effect as separate entries retroactively writing off the Michaels contracts to retained earnings and retroactively writing off the provision for deferred taxes to retained earnings (Tr. 663-665, Natelli Ex. M).

The entry which Scansaroli originally suggested to Buck with regard to the Michaels contracts was substantially the same as one he made in the PMM workpapers for the proxy statement. It accounted, however, for only the three largest Michaels contracts, and did not adjust a contract with Listerine that Michaels had reported. At some point during the work on the proxy statement in May, Natelli asked Scansaroli whether the entries had been made to

correct the deferred tax provision. Scansaroli told Natelli that in preparing the entries, he had determined that the tax adjustment was very close in amount to the gross profit on the Michaels contracts, so he simply rounded off the tax item and made a single entry. During the course of this coversation Scansaroli advised Natelli that one small item reported by Michaels, a contract with Listerine involving \$70,200 of gross income and \$49,200 of accrued costs, would be written off in the current year, not retroactively. Natelli said that unless the facts surrounding this contract were different from those of the other Michaels contracts, this contract should also be written off retroactively. As a result an entry was made in PMM's workpapers writing off the gross profit of \$21,000 on the Listerine contract to retained earnings and a similar entry was made in NSMC's books (Tr. 1863-1867).

Bernard Kurek, the principal Government witness, testified that at some point during the preparation of the originally proposed proxy statement, he had lunch with Scansaroli, who expressed concern as to whether they had made a right decision in the fall of 1968 as to the type of accounting to be used. According to Kurek, Scansaroli said he was concerned about his CPA certificate and "perhaps I ought to put it in a locked box at the bank" (Tr. 236-238).

Work on the proposed proxy statement was suspended because NSMC officials decided to delay the project so that it could include additional mergers that were being contemplated. In May, 1969, NSMC did, however, issue its own unaudited statement of earnings for the six-month period ended February 28, 1969. Included in the income for that period was an amount of approximately 1 million dollars which was based on a commitment from the Pontiac Division of General Motors Corporation evidenced by the following letter:

"This will confirm our recent conversations relative to our plans for use of the services of National Student Marketing Corporation in model year 1970. "You have submitted to us various proposals for directing sales influence toward the student population of the U.S. These proposals in total would require an outlay of approximately \$1,900,000.00.

"We are now planning to implement student influence proposals that would result in gross billings of

\$1,200,000.

"I will keep you informed as our plans progress." (Gx. 12).

From the first time Mr. Natelli saw the letter, he stated that when PMM was called on to audit the financial statements for the fiscal year ending August 31, 1969, he would not accept the letter as sufficient to justify the accrual of income since it did not meet the form of a binding commitment that had been prepared by Davies and agreed upon in December of 1968 (Tr. 518-520, 1877-1878).

In addition, during the late spring Natelli had some disagreement with NSMC officials because he refused to permit NSMC to utilize percentage of completion accounting for certain activities of two of its subsidiaries. Indeed, at a NSMC Finance Committee meeting held in the middle of May, 1969, Randell suggested that NSMC should consider replacing PMM as its auditors and complained that NSMC got only a third of what it wanted from an accounting standpoint. Two other officers at the meeting also expressed the view that PMM was not being aggressive in handling the NSMC account (Tr. 397, 506-512, Scansaroli Ex. E).

In June, 1969, Kurek and Natelli met for an hour and a half. Kurek's recollection of that meeting was limited to what was reflected in a three-quarter page memorandum of that meeting entitled "In Re: Meeting with Tony Natelli" which he sent to Randell the following day which stated:

"I met with Tony this morning from 9:30 to 11:00 incidental to our phone conversation yesterday. I reviewed with him the progress our profit planning and

budgets were making, the Finance Committee ideas incidental to a master cash pool and tax effects of consolidated Federal tax returns and stock options. After discussing the above and setting the atmosphere of the meeting, the subject of the meeting was changed to that

of NSMC's manner of booking contracts.

"Cort, quite frankly, Tony is very concerned about this situation. Last fall he felt that the manner in which he allowed us to book contracts would be a cyclical deal . . . [sic] in other words, we would be selling and delivering on contracts in the same quarter that financial reports were made. He now sees the situation as one where commitments either make or break us and we are not performing in the period the sale is made. Furthermore, he anticipates that unbilled receivables could be as high as \$4,000,000 at August 31, 1969. If so, he will have to give us a qualified opinion or perhaps no opinion. This is very serious, since it could adversely affect our registration this fall. He stated that people working under him are uncomfortable with this situation and if anything were to happen, their 'certificates' and careers would be at stake.

"Cort, he has reassessed the situation, and I feel is rather firm in his conviction and is going to be hard to move. Therefore, due to the seriousness of the matter and my feeling of his conviction, this is a very serious matter for NSMC.

"I invited him to our Finance Committee meeting of June 9, 1969 at 3 P.M." (Gx. 14, Tr. 232-234, 513-515).

While also having difficulty in 1974 recalling a specific meeting in June of 1969, Mr. Natelli testified that he did recall one or more meetings with Kurek in late May or early June in which he expressed his strong concern over the fact that the company had booked income in its unaudited statements on the basis of the Pontiac letter,

when in December of 1968 they had agreed on a form of definite commitment that was to be used in the future. Natelli recalled expressing his concern that the company was following policies in the preparation of its unaudited earnings reports which he would not be willing to accept when it came time for him to supervise the August 31, 1969 audit. He made Kurek aware of these concerns and stated that he wanted to have a meeting with Randell to make sure he was aware of those concerns (Tr. 1867-1874).

On June 9th, Natelli did attend a meeting at NSMC's offices in New York which lasted approximately 45 minutes to an hour (Tr. 247-248). Kurek's recollection of this meeting was again vague and was limited to information contained in four pages of typed notes prepared by Randell's secretary. These notes, which were introduced in evidence as Government's Exhibit 16, are on their face both inaccurate and incomplete.

According to the notes, Randell indicated that fixed fee contracts for the year were 3.3 out of a total of 6.1 million dollars of sales, and that while they started out the year with both verbal and written contracts. "All the written agreements have been fulfilled and none have had to be written off. As of February 28, no more verbal [sic]". Natelli reviewed the history of the decision to permit the use of percentage of completion accounting at August 31, 1968. Randell noted that while 30% of the oral commitments had been written off, none of the written contracts had been written off. In response to Natelli's statement that \$800,000 of the August contracts did not come through, Randell pointed out that 80-90% were Michaels contracts. According to the notes Natelli stated that of revenue of 3.3 million, only 1 million had been performed and 3.3 was sitting unbilled. Jim Jov and Don Ferguson, NSMC's two senior vice-presidents, supported Randell's assertion that NSMC's experience with written commitments was good,

and that the percentage of completion method was necessary to fairly match the company's costs and expenses. According to the notes Natelli stated:

"\$45 million in sales is fine but it's important that 3.3 is unbilled in balance sheet. Suppose we do run into problems . . . will you sue them . . . doubt if you have a case. I've got to look at the negative." (Deletion noted in original)

Natelli stated that he would like to see an increase in conservatism and no additional advanced recognition of income. He further stated that the company should not boost its earnings projections but should tone them down. Randell stated that they had not changed their projections in seven or eight months and reviewed some of the positive accounting changes the company had made. He concluded by stating to Mr. Natelli:

"You have our support and I feel that you are being fair . . ." (Gx. 16)

Apparently, Randell's final statement was something less than sincere, since at the July meeting of the Finance Committee, at which Mr. Natelli was not present, the NSMC officials again discussed the question of replacing PMM as the company's auditors (Tr. 416-418).

D. The Preparation of the Proxy Statement in August, 1969 and the Statements Alleged to Be Materially False

In late July or early August, 1969, work began again on the NSMC proxy statement. The principal item to be covered by this proxy statement was NSMC's acquisition of Interstate National Corporation, a Chicago based insurance company. This time, the proxy statement was to contain in addition to NSMC's audited financial statement for the period ending August 31, 1968, the company's unaudited statements for the nine months ended May 31, 1969.

1. The Footnote to the Audited Statement of Earnings

As noted earlier, between the time the original auditors' report for the period ending August 31, 1968 had been prepared and August of 1969, when the work on the proxy was taking place. NSMC had been engaged in an active acquisition program, during which it acquired a number of additional companies. In these circumstances, Statement on Auditing Procedure No. 40 issued by the American Institute of Certified Public Accountants ("AICPA") required that the financial statements for the year ended August 31, 1968 which were to appear in the proxy statement had to be prepared on a pooling of interest basis. That is the republished financial statements were required to reflect the combined operations of NSMC and the companies acquired subsequent to August 31, 1968, as if they had been operating in combination prior to that date (Tr. 1361-1362). Thus, whereas NSMC had in the fall of 1968 reported total sales of \$4,989,446, for the year ending August 31, 1968, the statement of earnings for the same period set forth in the proxy statement reported total sales of \$11,541,895 (Compare Gx. 5 and Gx. 25).

In addition to the inclusion of financial data for the acquired companies, the statement of earnings for the year ended August 31, 1968, reflected the write-off of the Michaels contracts, and the elimination of the deferred tax provision which was shown separately as an extraordinary credit.

Opinion 10 of the Accounting Principles Board of the AICPA suggested that when poolings of interest have been reflected in subsequently issued financial statements "the companies may wish to provide reconciliation of amounts of revenues previously reported with those currently reported in order to show the effect of poolings upon the earnings trends" (See Tr. 1363). In preparing the notes

to the audited financial statements to be printed in the proxy statement, Natelli drafted the type of trend of earnings note suggested by APB No. 10 and inserted in that note a separate line to reflect as "contract losses" the write off of the Michaels contracts. Thus, the first printed draft of the proxy statement, which was circulated to various lawyers, as well as, people at NSMC, PMM and Interstate contained a note which stated:

"(E) Net sales and earnings as originally reported to stockholders in the annual report for the years 1967 and 1968 and original prospectus for the year 1966 and the amounts as shown in the summary of earnings in this proxy statement are reconciled as follows:

| | 1966 | 1967 | 1968 |
|--|--------------------------------------|-------------|--------------|
| Net Sales: Originally reported | \$ 573,259 | \$2,386,500 | \$ 4,989,446 |
| Retroactive adjustment for contract losses (note C)* | | | (70,200) |
| Pooled companies reflected retroactively | 2,084,915 | 3,266,360 | 6,389,164 |
| | \$2,658,174 | \$5,652,860 | \$11,308,410 |
| Net Earnings (loss): Originally reported | (4,510) | 168,616 | 388,031 |
| Retroactive adjustment for contract losses (note C)* | | | (21,000) |
| Pooled companies reflected retroac- tively | 80,059 | 217,019 | 389,429 |
| Per summary of earnings | \$ 75,549 | \$ 385,635 | \$ 756,460" |
| | Name and Address of the Owner, where | | |

^{*} Note C read:

[&]quot;Retroactive adjustment was made in the consolidated statement of earnings for the year 1968 for certain contract losses and for recognition of effect on deferred taxes of related net operating loss carry-forwards. The net effect of the retroactive adjustment was a \$21,000 decrease in net earnings for the year 1968."

It was established at trial that, under normal procedure, a partner such as Natelli would draft the text of a footnote but that the actual figures to be inserted would be gathered by one of the accountants on the staff (Tr. 942, 1890). It was acknowledged that whoever put the figures in this draft footnote made an error and only picked up the Listerine contract in the contract losses line. See pp. 17-18 supra.

As Natelli worked on the first printed draft of the proxy statement, he came to the conclusion that the mere insertion of a contract losses line in the trend of earnings footnote did not give the reader sufficient detail as to the specifics of Ron Michaels' situation which gave rise to those losses. As he attempted to draft a more detailed note concerning Michaels' unethical conduct, he became concerned about printing this information in a public document and began to question whether discussion of this item was really necessary in light of the facts that NSMC had changed substantially since the original report was prepared, Michaels had been terminated, and the net effect on the "bottom line" of the write-off of the Michaels contracts and the deferred tax correction was only \$21,000 (Tr. 1905-1908).

Mr. Natelli did not unilaterally decide to eliminate the footnote disclosure of the Michaels write-offs. He discussed the matter with Leon Otkiss, a partner in PMM's Philadelphia office, who had recently been assigned as the "SEC reviewing partner" for the NSMC proxy statement and who had a copy of the printed draft. Natelli discussed with Otkiss the fact that although the sales that were written off were approximately \$700,000, the net effect on earnings of the Michaels' write-off and the correction of the provision for deferred taxes was only \$21,000. They also discussed the facts that the company had changed substantially since the date of the original report and that the company's procedures for booking commitments had been

changed so that now only written commitments were being accepted and that this should eliminate problems such as the write-off of the oral contracts that Michaels reported. Otkiss, who was 15 years older than Natelli and who was assigned as an SEC reviewing partner because he was "one of the most technically proficient partners in the firm," agreed that footnote disclosure of the contract write-offs was not necessary. As a result, the line for contract losses was deleted from the footnote that Natelli had originally drafted (Tr. 1741-1752, 1908-1910). In the process of eliminating the line for contract losses, the adjustment for the Michaels contracts and the deferred tax provision in this footnote ended up in the line entitled "Pooled companies reflected retroactively". Mr. Natelli testified concerning the reasons for this as follows:

"Trying my best to recall the situation, it would have been quite logical or it was quite logical that this is where the adjustment ended up. This is a note that has as primary objective the showing of a trend of net earnings of NSM as between the form that it was when it was originally reported in its previous report with whatever companies were involved and as it now existed with whatever companies were involved. Since we had concluded at that point that it was not necessary to make any narrative disclosure, logically the amount would fall into the line, if you will, that represented an adjustment from the previously reported to the presently reported company as it now stood.

That must have been the logical conclusion as to

where it ended up.

Looking at it now, I probably should have inserted the words on that line which reads pooled companies or whatever the full caption is. I can't see it from here. I probably should have included the words 'and adjustments' on that line, but that obviously was not done." (Tr. 1912-1913)

2. The Inclusion of the Eastern Contract in the Unaudited Nine-Month Statement of Earnings

In the course of the work on the proxy statement in August, Natelli's attention was again directed to the Pontiac commitment which NSMC had recorded as income in the unaudited statement of earnings it had released for February 28, 1969. During the course of a meeting on August 7, Natelli repeated to Kurek the position which he had consistently taken, that the letter which NSMC had received from Pontiac was not firm enough to support the inclusion of this item in the company's income and would not be accepted by him in connection with the audit PMM would shortly undertake for the year ending August 31, 1969. Kurek immediately sent a memorandum of this conversation to Randell and Roger Walther, who was the president of NSMC (Tr. 530-536, 1913-1916, Natelli Ex. H).

During this same period in early August, Natelli told Randell that he was not satisfied with the Pontiac documentation. During the course of their conversation Randell told Natelli that the company had a substantial commitment from Eastern Airlines, and was expecting to receive a written confirmation of that commitment within a few days (Tr. 1913-1914).

On August 14th, Natelli and Scansaroli were requested by Randell to fly to New York to spend the night at the printer's working on the financial statements for the proxy statement. That evening Randell, Kurek, John Buck, the comptroller of NSMC, John Stalick, another NSMC accountant, Natelli and Scansaroli flew from Washington to New York and arrived at Pandick Press in New York between 11:00 p.m. and midnight. Prior to leaving Washington, Natelli indicated to Randell that the documentation of the Pontiac commitment was not sufficient and that unless additional information was received, he would object to the Pontiac contract being included in the figures for May 31, 1969. Randell insisted, however, that the Pontiac commitment was good and offered to fly Natelli to Detroit

so he could meet with the Pontiac official involved.* During the course of the evening Natelli insisted that the Pontiac commitment should not remain in the May 31, 1969 figures. At some point Randell indicated to Natelli that NSMC had obtained the written confirmation of the oral commitment made in May by Eastern Airlines, which commitment was almost equal in amount to the Pontiac program. Randell suggested that since the two commitments were approximately equal, the Company would simply substitute the Eastern commitment for the Pontiac commitment without changing any of the unaudited May 31, 1969 figures that had already been printed for the proxy statement. Although it was the middle of the night, Randell had Kurek call Dennis Kelly, an account executive, to get the figures for the sales and cost of sales on the Eastern contract. These figures indicated, however, that the gross profit on the Eastern contract would be approximately \$200,000 less than the Pontiac program. Natelli concluded that, in no event, would it be proper for NSMC to keep the Pontiac figures in the nine-month statement of earnings in the proxy statement. Thus, despite the substantial cost involved, Natelli insisted that all the financial statements for the period ending May 31, 1969 in the proxy statement should be reprinted to delete the Pontiac contract (Tr. 539-540, 651-654, 672-679, 1914-1924).

While they were still at the printers, Natelli was asked whether, if the Pentiac figures were deleted, he would object if the company recorded the income from the Eastern contract in the unaudited statement of earnings for the nine months ended May 31, 1969, since the commitment letter was in the agreed upon form and confirmed an oral commitment made in May. Dennis Kelly, a NSMC vice-

^{*} This Pontiae official had apparently given assurances to representatives of White, Weld & Co., who were examining NSMC at the request of Interstate. Mr. Schauer, one of the lawyers for Interstate, testified that at a meeting of the Interstate Board of Directors in early August, a White, Weld representative advised the Board that he had contacted Pontiae and been assured that the million dollar commitment from Pontiae was good (Tr. 1070-1071).

president, came to the printers during the day of the 15th and gave Natelli a copy of the commitment letter from Eastern Airlines signed by the Manager of Special Markets which stated:

"This is to confirm our verbal commitment given to you on May 14, 1969.

"We will accept and utilize during the fiscal year, 1970, an amount of not less than \$820,000 for National Student Marketing Corporation's services as offered to us in your proposal originally submitted on May 7, 1969.

"We look forward to continued success in our youth marketing efforts and to our relationship with National Student Marketing Corporation." (Gx. 18)

Kelly also brought with him a copy of the detailed proposal that had been submitted to Eastern Airlines in May and reviewed with Natelli the various components of the program and the costs allocable to them. Natelli left the printers on August 15th without having made any decision concerning the booking of the Eastern contract. He stated that he wanted additional time to consider the Eastern situation (Tr. 682-683, 1925-1928).

During the following week Natelli obtained from NSMC the time sheets of Robert Bushnell, the account executive who had the primary responsibility for the Eastern Airlines account. After reviewing these time sheets which showed that Bushnell had spent over 110 hours on the 1970 Eastern program prior to the end of May, 1969 and again speaking to Kelly on the telephone, Natelli finally decided that he would not object if NSMC included income from the Eastern contract in the unaudited statement of earnings for the period ended May 31, 1969. Thus, when the proxy statement was subsequently reprinted to delete the sales and earnings on the Pontiac commitment from the ninemonth unaudited financial statements, the sales and earnings on the Eastern contract were added. The result of

these changes was to reduce sales and earnings by approximately \$400,000 and \$200,000, respectively, from those that would have been reported had Natelli not insisted that the Pontiac commitment be deleted from NSMC's books (Tr. 541-544, 680-682, 769-770, 1925-1929, Natelli Ex. J, Gx. 13, E. 111).

3. The Inclusion in the Unaudited Figures of the Commitments Questioned by Oberlander

On August 14th, Scansaroli assigned Douglas Oberlander, one of the PMM accountants working on the NSMC engagement, to conduct a review of the contracts in progress on NSMC's books. Oberlander conducted this review and prepared a schedule of items which he thought the company should write off. Oberlander discussed these items with Kulek, who insisted that they should not be written off. Oberlander then reported these facts to Scansaroli, who said he would review these items with Kurek (Gx. 13, E. 112-117; Tr. 402-405, 751-762, 793-803, 1551-1552).

Neither Kurek nor Scansaroli had any precise recollection of their meeting. Each testified only that they recalled meeting to discuss the items questioned by Oberlander, and that they had gone over each of the items and decided that the company would write off the largest single contract in Oberlander's schedule, a Syntex commitment of \$120,000, and that the rest would remain on the books. Kurek, who was the Government's principal witness at the trial, testified that nothing improper was involved in the making of these decisions, and he and Scansaroli were simply trying to do their best to reflect fairly the financial picture of the company (Tr. 405-408, 1551-1553).

E. The Events Subsequent to the Preparation of the Proxy Statement

After the bulk of the work on the proxy statement was completed, PMM's next major assignment for NSMC was

the audit of NSMC's financial statements for the year ended August 31, 1969.

Early in the audit, Natelli had a discussion with John Johnston, a senior accountant assigned to that audit, in which he advised Johnston that a substantial portion of the unbilled receivables recorded during the August 31, 1968 audit subsequently had to be written off, and that he wanted Johnston to prepare a detailed audit program to take a hard look at the unbilled receivables on NSMC books at August 31, 1969. Natelli also indicated that he wanted to follow a procedure of obtaining positive written confirmations on all unbilled receivables (Tr. 909-910; 947-952).

Acting pursuant to these instructions, Johnston drew up a seven-step procedure for auditing the unbilled receivables which he showed to Natelli. After adding three additional steps to the program, Natelli forwarded the audit program to William Colona, who had been assigned to replace Scansaroli as supervisor on the NSMC engagement after Scansaroli left PMM to become an assistant comptroller at NSMC. Natelli forwarded the audit program for the unbilled receivables to Colona with a handwritten note that read:

"Bill,

Attached is Program for contracts at NSMC. Please get into this as first order of business. Satisfy yourself that procedures are adequate.

AN"

(Natelli Ex. N, Tr. 953, 1776-1779, 1934-1935)

Natelli subsequently spoke to Colona personally and advised him that there had been problems with the unbilled receivables in the past and stated that they should be sure that all NSMC contracts were in writing and that he wanted these contracts confirmed 100% (Tr. 1778-1779, 1935).

Those procedures were followed during the course of the NSMC audit, and the NSMC financial statement for the year ended August 31, 1969 included unbilled receivables for the parent company of 1.8 million dollars.* This was approximately the same as the amount of unbilled receivables reflected in the unaudited statement of earnings for the period ended May 31, 1969 set forth in the proxy statement (Tr. 973).

The acquisition of Interstate National Corporation by NSMC which had been one of the subjects of the proxy statement was scheduled to close on October 31, 1969. Pursuant to the terms of the acquisition agreement, NSMC was required to supply Interstate with a "comfort letter" from PMM to the effect that a limited review of NSMC's unaudited financial statements had been conducted and that as of a date no more than five business days prior to the closing, no material adjustments were required in the interim financial statements for the period ended May 31, 1969 (Gx. 25, E. 279-280).

On October 24th Natelli reminded Colona that he would have to consider whether any of the audit adjustments being made to the year end statements would have any effect on the unaudited statements of May 31, 1969. Natelli had a similar conversation with John Johnston. While Johnston could not recall the specifics of this conversation at the trial, he did acknowledge testifying before the SEC that during the course of this conversation he told Natelli that he thought there would be problems in the area of old unbilled receivables, some deferred costs on per inquiry programs and some charges to additional paid-in capital and that Natelli agreed that such adjustments should be disclosed in the comfort letter (Tr. 918-926, 957-959, 1780-1781).

[•] An additional \$900,000 of unbilled receivables were ultimately included in the consolidated financial statements for the period ending August 31, 1969, but these were attributable to a subsidiary company which was audited by another accounting firm (Tr. 973).

The closing was scheduled for a Friday and during the early part of that week, Johnston and Colona worked to determine the exact amount of the adjustments that should be made to the unaudited statements of May 31, 1969. They determined that the income which NSMC reported for the nine-month period in the proxy statement, \$702,270, should be reduced by three categories of adjustments which together totalled \$784,000. The largest item was an amount of \$500,000, which represented the end of the year write-off of deferred costs attributable to per inquiry programs completed prior to May 31, 1969. Another \$200,000 adjustment resulted from the fact that at year end, the company had written off an additional \$372,000* of gross commitments on fixed-fee programs on which there were accrued costs of \$166,000. The final adjustment of \$84,000 involved expenses of acquisitions which had originally been recorded as charges to paid-in capital but which had to be expensed because the acquisitions were not finalized (Tr. 926, 1782-1783, Natelli Ex. K).

By the end of the day on Thursday, October 30, 1969, Colona and Johnston had isolated the adjustments to be made and given a copy of a draft of the comfort letter to Kurek. That evening Colona called Natelli, who had been home sick on Wednesday and Thursday, and advised him of the magnitude of the comfort letter adjustments. Natelli told Colona to call Mr. Otkiss, the SEC reviewing partner, the first thing the next morning and alert him to the problem and said that he would be in the office some time the following morning (Tr. 1784-1785).

October 31, 1969, the day of the closing, Natelli arrived at the office and was told by Colona that Otkiss had been contacted. As the day progressed, there were conference

[•] The amount of this write-off was actually overstated in the comfort letter because Johnston and Colona erroneously included the Syntex commitment of \$120,000 in the write-offs, even though that commitment had been written-off and deleted from the figures at the time the proxy statement was prepared (Tr. 1783).

calls among Natelli, Otkiss and Tom Holton, the head of PMM's SEC review committee, as well as calls between Holton and Victor Earle, PMM's general counsel. In addition, a copy of the draft comfort letter showing the material adjustments was transmitted to NSMC's lawyers at White & Case, who were told that the letter was not yet in its final form (Tr. 1791-1795, 1427, 1438-1441).

As the result of the communication among the PMM group that took place on that day, certain changes were made in the draft comfort letter. When Mr. Holton telephoned the final change to the partner at White & Case, he was surprised to learn that the parties had closed the merger without waiting for the comfort letter from PMM in final form (Tr. 1796-1799).

Bernard Kurek, the principal Government witness, testified that he was in Mr. Natelli's office on the afternoon that the comfort letter was being prepared, that he listened on a speaker phone to a conversation between Mr. Natelli and the White & Case partner, and that during this conversation Mr. Natelli suggested that the company should go to the SEC with the problem (Tr. 555).

The company did not, however, go to the SEC with the problem. Although PMM considered bringing the problem to the SEC, Mr. Earle testified that he decided against such action because to do so might violate certain state laws and the AICPA Code of Professional Responsibility relating to confidential communications between accountants and their clients, as well as, SAP 41 which had just become effective. He did, however, have PMM manifest its concern over the fact that the Interstate transaction had closed despite the comfort letter adjustments by sending copies of the final comfort letter to each member of the board of directors of NSMC and of Interstate (Tr. 1442-1445).

After the Interstate closing, NSMC had closings scheduled with three smaller companies which had received copies of the proxy statement containing the May 31, 1969

financial statements, but whose acquisition agreements did not require NSMC to furnish them with a comfort letter from PMM. Mr. Natelli insisted, however, that each of these companies be given copies of the comfort letter (Tr. 554, 1946-1947, Natelli Ex. L).

Summary of Argument

At the time he sentenced appellant Natelli and coappellant Scansaroli, the trial judge stated:

". . . I think you are absolutely sincere when you say that you did not believe that you did anything wrong on this audit or audits for National Student Marketing. After thinking about this matter for a long time, I think you honestly mean that. But the tragedy is that the jury found that this was an audit or audits done with reckless disregard for what was really involved. We know that because of the record showing what it did in the jury deliberation." (A. 284)

This statement reflects a basic error that resulted in the conviction of these two innocent men. Despite the fact that the Government's proof failed to establish that these two defendants actually knew that the proxy statement was materially false in the respects alleged, the jury was led to convict by a number of errors in the charge of the court and the admission of evidence which obfuscated the distinction between recklessness and the "knowing" and "willful" conduct which Congress has proscribed. While proof of a conscious disregard for the facts has previously been accepted by this Court as evidence that a defendant actually knew that his statements were false, in this case evidence of reckless failure to realize the statements might be false was apparently accepted as the sufficient basis for criminal conviction. Indeed, the proof was such as to persuade the trial judge that the defendants' conduct lacked the element of "conscious" wrongdoing which the statutory terms "willfully and knowingly" embody. See Morissette v. United States, 342 U.S. 246, 252 (1952); United States v. Benjamin, 328 F.2d 854, 861 (2d Cir.), cert. denied sub nom. Howard v. United States, 377 U.S. 953 (1964).

The evidence submitted by the Government was not sufficient to satisfy reasonable men beyond a reasonable doubt that the appellant Natelli knowingly engaged in criminal Indeed, the evidence bearing most directly on Mr. Natelli's state of mind at the time strongly supported the conclusion which the trial judge reached, that he never believed that he was doing anything wrong. This evidence included proof that just after working on the proxy statement at issue, Natelli instructed both the supervisor and the senior accountant working under him to take a "hard look" at NSMC's unbilled receivables, that at the time of the Interstate closing, he suggested that the problems that had arisen should be brought to the attention of the SEC, and that he later insisted that copies of PMM's letter, which disclaimed "comfort", be delivered to other companies that NSMC was acquiring.

The case should never have been submitted to the jury. But even if the Court were to disagree, the question of sufficiency was so close that it was particularly important that the events at issue be properly presented to the jury. See *United States* v. *Garguilo*, 310 F.2d 249 (2d Cir. 1962). Unfortunately, the charge of the court misled the jury on the proper meaning of the critical statutory language "willfully and knowingly," led the jury to believe that an outside auditor has the same responsibility for unaudited financial statements as when he is performing an audit, failed to charge that in determining materiality the entire context must be considered, failed to charge that knowledge of materiality was an essential element of the crime, and misstated some of the most important factual issues.

The court also erred in permitting the Government to introduce evidence of a good faith error in resolving a com-

plicated accounting issue as a basis for arguing that this mistake evidenced criminal conduct, without the slightest proof that this was anything other than an honest human error. In addition, given the fact that this trial occurred so long after the events at issue and that the central issue involved the state of mind of the two defendants, it was error for the trial court to exclude expert testimony that Mr. Natelli and his co-defendant had taken lie-detector tests and were found to be truthful when they stated that they did not know that the NSMC financial statements were false and misleading.

We also submit that the conviction of Mr. Natelli should be reversed and the indictment dismissed because just prior to the start of the trial, the Chief Accountant of the Securities and Exchange Commission, who had direct and substantial involvement in this prosecution, met with representatives of the press and made a statement indicating his personal belief in the guilt of appellants and this statement was published in an article that appeared during the trial.

Finally, we submit that the court erred in denying the appellant's motion to dismiss for lack of venue the one count in which Mr. Natelli was named. Under the applicable venue statute, a prosecution for making a false statement in a document filed with the SEC can only be brought where the act "constituting" the offense "occurred."

While each of the errors that we cite alone requires reversal, their combined effect clearly deprived appellant of his right to have his case fairly presented to the jury. Although some of the errors relate to only one of the two specifications of falsity alleged in the indictment, such an error requires reversal since it cannot be determined which specification provided the basis for the jury's verdict. United States v. Adcock, 447 F.2d 1337 (2d Cir.) cert. denied, 404 U.S. 939 (1971).

POINT I

The evidence was not sufficient to establish that Mr. Natelli knowingly assisted in the filing of a false proxy statement with the Securities and Exchange Commission, or even that the proxy statement was materially false in the respects alleged.

While the evidence at trial covered a number of events spanning more than a year, the charge against Mr. Natelli in the indictment was limited to the specific allegations that he knew that the proxy statement of September 1969 was materially misleading, because (1) it did not contain a narrative discussion of the fact that sales, costs and earnings from certain commitments originally accrued at August 31, 1968 had been written off, and (2) the unaudited statement of earnings for the nine-months ended May 31, 1969 allegedly overstated sales by approximately \$813,000 and allegedly overstated earnings by \$700,000. (See Indictment, Count 2, ¶¶ 3 and 4.) (A. 24-25).*

In order to sustain the conviction in this case, the Government was required to prove (1) that the proxy statement was a document required to be filed and was materially false and misleading in one of the two material respects alleged, and (2) "that the defendant knew it to be and deliberately sought to mislead". United States v. Simon, 425 F.2d 796, 798 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970).

^{*}The allegations of the indictment relating to the unaudited figures for the nine-months ending May 31, 1969 were supplemented by the bill of particulars which listed the specific contracts totalling \$837,202 which the Government claimed should not have been included in the May 31st earnings. This list consisted primarily of the Eastern contract and the contracts which were questioned by Oberlander in his review at the time the proxy statement was prepared. The allegation relating to the overstatement of earnings related primarily to the comfort letter adjustments but there was no evidence or contention by the Government that the auditors were aware of these adjustments at the time the proxy statement was filed.

We shall demonstrate below that the Government failed even to prove the basic allegation that the NSMC financial statements were materially false and misleading in the respects alleged. We start, however, with the fact that the Government totally failed to prove that Mr. Natelli acted with the necessary "culpable state of mind". United States v. Benjamin, supra at 861; Morissette v. United States, supra.

A. There Was No Evidence That Mr. Natelli Knowingly Made Materially False Statements.

Insofar as Mr. Natelli is concerned, the charges contained in the indictment rested on two judgments that he made: (1) the decision that footnote treatment of the retroactive write-off of the Michaels contracts was not necessary, and (2) the decision not to object to NSMC's inclusion of the Eastern commitment in its unaudited statement of earnings for the period ended May 31, 1969.

At trial the Government did not offer any contemporaneous statements by Mr. Natelli in which he indicated that he knew these decisions were improper; nor did they offer any subsequent inconsistent statements by Mr. Natelli from which it could be argued guilty knowledge might be inferred.

The only evidence offered by the Government dealing with Mr. Natelli's state of mind was the evidence that two months prior to the date of the decisions in question, Natelli expressed concern to Kurek that unbilled receivables could go as high as \$4 million by the end of the August 31, 1969 fiscal year, that the people under him were uncomfortable and, if anything were to happen, their certificates and careers would be at stake, and that Natelli expressed concern about the contracts-in-progress at a Finance Committee meeting shortly thereafter.

Given the fact that the unbilled receivables never approached \$4 million and, indeed, did not go above the \$1.9

million reported at May 31, 1969—in part as a result of Mr. Natelli's insistence in August that the Pontiac letter was not a sufficient commitment—the above statements of Mr. Natelli in June are hardly sufficient to establish beyond a reasonable doubt that he acted with a culpable state of mind in August. More important, however, is the fact that there was other positive evidence which demonstrated that Mr. Natelli did not act with a culpable state of mind.

In the first place, the decision that footnote discussion of the Michaels write-offs was not necessary was not made by Natelli alone. He followed the appropriate procedure in such circumstances and discussed the matter with his SEC reviewing partner, Mr. Otkiss. Compare *United States* v. Simon, supra at p. 809 where the Court took note of the defendant's failure to consult the proper reviewing partners as evidence of criminal intent.

The testimony that Mr. Natelli consulted with Mr. Otkiss was far from the only evidence of lack of criminal intent. As this Court has often indicated, the conduct of an individual after the events at issue is often relevant in determining whether he has engaged in conscious wrongdoing. See, e.g., United States v. Cirillo, 468 F.2d 1233 (2d Cir. 1972), cert. denied, 410 U.S. 989 (1973).

Here the Government's case was premised on the theory that Mr. Natelli assisted in the preparation of false financial statements for the proxy statement in order to corrup mistakes made during the prior year's audit. The evidence of Mr. Natelli's conduct subsequent to the work on the proxy statement totally refutes this contention that he was engaged in what the Government repeatedly characterized as a "cover-up" and manifests a total lack of a guilty mind.

After PMM's work on the proxy statement was completed its next major assignment for NSMC was the audit for the fiscal year ended August 31, 1969. At the start of this work, Mr. Natelli told both John Johnston and Bill Colona,

who were, respectively, the senior accountant and supervisor assigned to this work, that there had been substantial write-offs of NSMC's unbilled receivables accrued in the prior year, and that he wanted them to take a hard look at these items and to satisfy themselves that the audit procedures were adequate. He told them that he wanted them to be sure that NSMC was recording income only on written contracts, and that all of these contracts should be confirmed in writing.

This conduct was clearly not designed to "cover-up" any problem that existed at NSMC and, indeed, it did not. As a result of the work that Johnston and Colona did on the audit of NSMC, it was determined that the comfort letter for the Interstate closing should disclose adjustments of close to \$800,000 to the statement of earnings for the period ending May 31, 1969. Here again, Mr. Natelli encouraged his assistants to check to determine what adjustments were necessary and took the proper step of calling in his SEC reviewing partner when the problems appeared.

Also revealing as to Mr. Natelli's state of mind was the testimony of Bernard Kurek, the chief Government witness, that on the day of the Interstate closing, he was present in Mr. Natelli's office when Mr. Natelli was talking on the telephone to the partner at White & Case who was in charge of the NSMC account. Kurek testified that during the course of their discussion about the comfort letter, Mr. Natelli said that the company should go to the SEC with the problem (Tr. 555).

Certainly a man who acted with a culpable state of mind in preparing a false proxy statement in August would not have suggested bringing this matter to the attention of the SEC in October. Nor would such a man do what Mr. Natelli did thereafter when he insisted that NSMC deliver copies of the comfort letter to three smaller companies whose acquisition agreements did not provide for the delivery of a comfort letter (Tr. 554).

In sum, the record is not merely devoid of evidence that appellant acted with the "culpable state of mind" which is a prerequisite of a conviction for knowingly filing a false statement with the SEC, it is replete with evidence that Mr. Natelli acted in complete good faith.

In all events, it cannot be said that there was such proof as to allow a jury to find beyond a reasonable doubt that he "willfully and knowingly" participated in the filing of materially false statements with the SEC.

B. The Government Failed To Prove That The Proxy Statement Was Materially False In The Respects Alleged.

An analysis of the evidence shows that the Government failed to prove that the proxy statement was in fact "materially false" in either of the respects alleged.

1. The Absence of Footnote Disclosure of the Michaels Write-off's Was Not Material.

The first specification of falsity in the indictment relates to the fact that there was no footnote discussion in the proxy statement of the fact that approximately one million dollars of the unbilled receivables originally reported for the period ending August 31, 1968 had subsequently been written off. The major portion of these write-offs were the contracts of Ron Michaels that are discussed above. See Statement, supra, p. 15. The remainder were contracts totalling \$212,000 of sales on which there were approximately \$100,000 of accrued costs which the company wrote off in 1969 against current operations, and which the Government witness John Buck characterized as "immaterial" (Tr. 660).

In considering the materiality of these items, it is important to recognize the sales and earnings figures stated in the proxy statement had, in fact, been reduced by the amount of these items. Thus, government witness Ian Dingwall, a SEC staff accountant, acknowledged that the

write-off of the Michaels contracts was reflected in a decrease in the sales and income for the period ended August 31, 1968 reported in the proxy statement, and that the other write-offs made by NSMC had reduced the sales and income for the hine-months ended May 31, 1969 (Tr. 1291, 1295-1296). Thus, the determination of the materiality of the lack of footnote disclosure has to be made in the light of the fact that the sales and earnings reported for the period ending August 31, 1968 in the proxy statement were not even alleged to be overstated.

Furthermore, the acquisition by NSMC of a number of companies after the original report for the period ending August 31, 1968 was published necessitated a complete restatement of all of the figures for that fiscal year in order to combine the sales and earnings of the acquired companies as of that time with those of NSMC. These retroactive restatements were required by the principles of "pooling of interests" accounting. The result of this required accounting treatment was a retroactive increase of over six and a half million dollars in the statement of sales and a doubling of reported profits. Since the company was, therefore, reporting sales and earnings for that period of \$11,541,895 and \$773,152, respectively, it is easy to see why no one at the time concluded that footnote discussion of the Michaels write-offs was necessary when the difference between the net earnings on those contracts and the credit for the deferred tax item was only \$21,000.

Indeed, the evidence of the Government's own witnesses supports the conclusion that at the time the proxy statement was prepared, no one thought that footnote discussion of the write-offs was material or necessary. Thus, government witness John Buck, a CPA who was not alleged to be a participant in any wrongdoing, testified that, as NSMC's comptroller, he had responsibility for reviewing the financial statements in the proxy statement and that he did not consider footnote discussion of the write-offs

necessary:

"Q. Is it your best recollection, sir, that you were aware at the time that the retroactive adjustments that had been made were reflected in that pooled company's line in the footnote that appears on those documents? A. Yes, sir.

Q. Sir, did you ever suggest to anyone that proxy statement should contain a footnote setting forth, disclosing the fact that there had been the write-offs of the August 31, 1968 sales that you testified about

here today? A. No, sir." (Tr. 684-685)

Similarly, the only testimony of prosecution witness Bernard Kurek on the subject of the need for footnote discussion of the write-offs occurred during his cross-examination when he admitted telling the SEC in January 1970

"since the net effect of the write-off was only \$21,000 we did not want to clutter our proxy statement with additional explanations and therefore recognized the \$21,000 in the note D to the consolidated statement of earnings under net sales pooled companies reflected retroactively or the \$385,000." (Tr. 629)

On its re-direct examination of Kurek the Government did not ask him any questions to suggest that this was anything other than his honest belief at the time.

Thus, the testimony of the Government's witnesses supports the conclusion which both Mr. Natelli and Mr. Otkiss testified they reached in August of 1969, that, under the circumstances at that time, it was not material to describe in narrative form the write-offs of some previously reported sales that had been claimed by a since dismissed employee, especially since the net effect of the write-offs was financially inconsequential. Mr. Natelli's reasoning that disclosure was not necessary because the employee had been dismissed and the procedures for accruing income had been changed at his insistence to require written com-

mitments is totally consistent with this court's teaching in *United States* v. *Simon, supra*, that where the financial statements are correct an accountant does not have to make narrative disclosure of problems uncovered during his accounting work if "he has made sure the wrong has been righted and procedures to avoid repetition have been established." 425 F.2d at 807.

The accounting judgment that these items were not material, which Otkiss and Natelli made at the time, is supported as a matter of law by the decision in Escott v. BarChris Construction Corp., 283 F.Supp. 643 (S.D.N.Y. 1968). In BarChris the year-end financial statements of the company reported sales of \$9,165,320, and Judge McLean found that those sales were actually overstated by \$654,900. He concluded, nevertheless, that this overstatement of sales was immaterial even though it resulted in an overstatement of net operating income by \$246,605. Here, unlike BarChris, there is no contention that the figures actually stated in consolidated earnings of NSMC for the year ended August 31, 1968 were misstated. Here the charge is only that there was a failure to disclose that the company, which was reporting sales for the period ended August 31, 1968, of \$11,541,895, had retroactively written off sales of approximately \$750,000. In the present case the sales that were written off were a smaller percentage of total sales reported than were the sales actually over-stated in the financial statements involved in BarChris. In addition, because of the retroactive tax adjustment here. the net impact on earnings was only \$21,000, which was substantially less than that involved in BarChris. See also Crane Corp. v. Westinghouse Air Brake Co., 419 F.2d 787. 799-800 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970).

Finally, before concluding the question whether footnote discussion of the items in question was material, it is important to note that it would be unfair to evaluate that judgment on the basis of facts and perceptions available only with hindsight. Mittendorf v. J. R. Williston &

Beane, Inc., 372 F. Supp. 821, 828-29 (S.D.N.Y. 1974). At trial five years after the collapse of NSMC, it was impossible to recreate the atmosphere of the securities markets in 1969 or the enthusiasm which NSMC generated. Yet, there are some facts of record which indicate that the perception of NSMC in 1969 was far different from that presented at the trial in 1974. The most significant item in this regard is the fact that the directors of Interstate proceeded with the merger with NSMC, even though they had received a draft comfort letter from PMM indicating that the unaudited earnings of \$702,270 for the nine-months ended May 31, 1969 reported in the proxy statement would have to be reduced by adjustments of \$884,000.* With hindsight it is difficult to understand why experienced businessmen would have decided to proceed with the merger at that point, yet the fact is that the Interstate board, acting with the advice of skilled counsel, Lord, Bissel & Brook of Chicago did make that decision. Certainly the fact that the Interstate board proceeded with the closing after learning that the reported earnings of the company would have to be reduced by \$884,000 sheds some light on the atmosphere in which Mr. Natelli and Mr. Otkiss concluded that the write-off of the Michaels contracts was not a material fact that had to be disclosed.** See General Time Corp. v. Talley Industries, Inc., 403 F.2d 159, 163 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969) where the Court stated the "test" of materiality in a civil case to be "whether, taking a properly realistic view, there is a substantial likelihood that the misstatement or omission may have led" the investor to take action "whereas in the absence of this [misstatement or omission] he would have taken a contrary course."

^{*} There was an error in the draft which the Interstate people received at the closing; the actual reduction was only \$784,000 (Tr. 1783).

^{**} Similarly, counsel for NSMC, White & Case, did not think that the "comfort" letter required the taking of any steps.

2. The Government Failed to Prove that the \$813,000 of Sales for the Period Ending May 31, 1969 Were in Fact Fraudulent As Charged In the Indictment Or that Appellant Knew of Any Such Fraud.

Paragraph 4 of the indictment alleged that the proxy statement was false in that sales for the period ended May 31, 1969 were stated to be \$11,313,569, while in fact "net sales' for that period were less than \$10,500,000". The bill of particulars furnished by the Government stated that the figure of \$11,313,569 of net sales stated in the proxy "is materially false and misleading in view of its inclusion of the following items" and then proceeded to list specific contracts totalling \$837,202, thus bringing the proper figure for net sales, as the indictment charged, to just under \$10,500,000. The largest single item listed in the bill of particulars was the Eastern Airlines item of \$519,152, and the remainder of the items consisted primarily of the items which Oberlander questioned during his review and which Scansaroli discussed with Kurek.

a. The Eastern Contract.

Consistent with the indictment and bill of particulars, counsel for the Government argued to the jury that the Eastern contract was "a complete phony" (Tr. 2295). To support the conviction on this specification of falsity, the Government was required to prove (1) that the Eastern contract was false, and (2) that Natelli knew it to be so. United States v. Simon, supra. The Government never proved even the primary element, i.e., that the Eastern commitment was in fact "phony".

The Eastern commitment was evidenced by a letter on the letterhead of Eastern Airlines signed by the Manager of Special Markets, Thomas Mullen.* It was in the form of the legally binding commitment drafted by NSMC's house counsel. It confirmed an oral commitment made in

^{*} The letter is quoted in full at p. 29 supra. It began:

[&]quot;This is to confirm our verbal [sic] commitment given to you on May 14, 1969."

May. It was delivered to Natelli by Dennis Kelly, a NSMC vice-president, along with a copy of a proposal for programs to be used by Eastern Airlines which indicated on its face that it was submitted to Eastern Airlines in May.

If this commitment was, in fact, "phony" as the Government contended, where was the proof? There was no evidence that (1) it was not signed by Mr. Mullen of Eastern Airlines; (2) it was not a legally binding commitment; or (3) Eastern had not made such a commitment to NSMC in May. Thus, despite the prosecutor's assertion that it was "phony", there was no proof to support this essential premise of the charge of making a materially false overstatement of sales.

Given this failure to prove an essential element of the offense, the conviction cannot stand. *United States* v. *Diogo*, 320 F.2d 898 (2d Cir. 1963); *United States* v. *Adcock*, 447 F.2d 1337 (2d Cir.) *cert. denied*, 404 U.S. 939 (1971); *United States* v. *Travers*, 2d Cir. Docket No. 74-1737, decided November 16, 1974.

In addition, even if there had been evidence that the Eastern contract was "phony"—and from the record there is no way of telling whether it was invalid for some reason—the proof was not sufficient to establish beyond a reasonable doubt that Natelli knew that it was invalid.

Mr. Natelli testified without contradiction that he was told in early August, 1969, before the meeting at the printer, that Eastern Airlines had orally given a major commitment and that written confirmation was expected shortly (Tr. 1913-1914).* When the Eastern letter was de-

^{*} If the Government disputed this testimony, Randell, who had already pleaded guilty, could have been called to testify. Moreover, there is nothing unusual about lawyers and accountants being at a financial printer at 3 a.m. Yet, the prosecutor continually attempted to portray this work at the printers at 3 a.m. as a sinister event—at one point comparing appellant's conduct to a "doctor at three o'clock in the morning down in his cellar burying a fresh corpse" (Tr. 2286; see also Tr. 2268, 2295-96, 2304).

livered to him at the printer it was, on its face, a genuine document. Moreover, Mr. Natelli did not immediately decide not to object to the inclusion of this item in the company's unaudited figures. The testimony of the Government's own witnesses is consistent with Mr. Natelli's testimony that his decision to accept the Eastern contract was not made at the printer's but rather was made the following week. Before making that decision, Mr. Natelli spoke to Dennis Kelly, a NSMC vice-president, who confirmed the existence of the commitment and explained the various components of the Eastern program. In addition, Mr. Natelli obtained the time sheets of the account executive in charge of the Eastern account and verified that he had spent a substantial amount of time prior to the end of May working on the programs to which Eastern committed itself in the letter. As an outside auditor, Mr. Natelli had only limited responsibility for unaudited financial statements published by the company (see pp. 58-60 infra).* There is simply nothing in the evidence to indicate that. in doing more than he had to, Mr. Natelli somehow discovered some "phoniness" to the Eastern commitment that the Government failed to prove at trial. United States v. Infanti, 474 F.2d 522, 526-27 (2d Cir. 1973).

The evidence was not sufficient to establish beyond a reasonable doubt either that the Eastern commitment was "phony", or that, if it was, Mr. Natelli actually knew it.

^{*}Since both audited and unaudited statements of earnings were being published in the proxy and Mr. Natelli knew that the Pontiac letter did not meet the binding form of commitment letter that he would require at the audit for the year ending August 31, 1969 which would soon begin, it was appropriate for him to insist that the company not include the Pontiac commitment in its unaudited figures (Natelli Ex. H, Tr. 1919). AICPA, Statement on Auditing Standards 1 § 516.06, 1 CCH AICPA Professional Standards. The Eastern commitment did, however, meet the form required and, given its apparent validity, there was no reason for him to audit this commitment. Id. at 1, § 516.02.

b. The Commitments Questioned By Oberlander.

The remainder of the contracts whose inclusion in the unaudited nine-month statement of earnings was allegedly criminal consisted primarily of the contracts questioned by Oberlander during his review.* The Government witness Kurek testified that the decision to leave a portion of these on the company's books as of May 31, 1969 was one that he and Scansaroli made at a meeting during which they made a good faith effort to arrive at a fair presentation of the company's financial condition. The Government offered no testimony that Oberlander's work papers were brought to Natelli's attention. testimony on this subject was Mr. Natelli's own that he was aware that Oberlander had questioned some item and he asked Scansaroli to follow up and review them (Tr. 2093-2096). This testimony by appellant hardly suffices to prove beyond a reasonable doubt that Natelli knew that the inclusion of the amounts represented by these contracts on the unaudited financial statements rendered them materially false and misleading.

POINT II

The trial court erroneously instructed the jury on the issue of knowledge and on other critical factual and legal issues.

The statute upon which this prosecution was based provides criminal penalties only for those who "willfully and knowingly" make a materially false statement in a document required to be filed with the SEC. These statutory terms impose a duty on the trial judge to instruct the jury

^{*} There were a few additional contracts which Scansaroli had questioned during the work on the proxy statement originally proposed for the period ending February 28, 1969. These were not questioned by Oberlander in his final review, and in any event, there was no evidence that any of these was called to Mr. Natelli's attention.

clearly that in order to return a guilty verdict, they must find that the defendant engaged in "conscious" wrongdoing. *Morissette* v. *United States*, 342 U.S. 246, 252 (1952).

The charge of the court was deficient in a number of specific respects. While each of these errors alone would warrant reversal, almost all of them were interrelated and thus each of these errors compounded the prejudicial effect of the charge as a whole.

A. The Court Gave An Unwarranted And Improper Charge On "Reckless Disregard" Which Confused The Jury On The Critical Issue of Knowledge And Intent.

The record shows unmistakably that this case was tried. submitted, and decided on an erroneous theory of law, namely, that the appellant as an independent accountant could be convicted of "willfully and knowingly" making a false statement to the SEC, if his failure to discover the falsity of NSMC's financial statements was the result of some form of gross negligence. While in a rare case, evidence of a "conscious" disregard of the facts may be sufficient for the jury to infer that the defendant must have realized the falsity of the statements and deliberately closed his eyes in an attempt to avoid obtaining actual knowledge, recklessness alone cannot itself be a sufficient basis for culpability under this statute. Yet, despite defense counsel's protests, that is the theory on which appellant was tried and convicted. The jury's principal concern was whether the defendant acted "knowingly" but their assessment of this vital issue was based on an erroneous charge on the concept of "reckless disregard" which was totally unwarranted by the evidence relating to specific actions of appellant that were challenged by the indictment.

As the record of the jury's deliberation shows, the jury was patently puzzled by the meaning of the statutory requirement that the defendant act "knowingly." The court initially charged that appellant could be convicted of knowingly and wilfully filing a false statement if the jury found

that he acted with reckless indifference to its truth or falsity (Tr. 2364-65). Defense counsel objected (Tr. 2383).* After some deliberations, the jury sent out a note asking that the instructions on "wilfully" and "knowingly" be clarified (Tr. 2400). In reinstructing on these elements, the court omitted any reference to recklessness as a basis for convicting, and the prosecutor objected to that omission (Tr. 2411). The court nevertheless left the point alone. After another period of deliberations the jury reported that it was deadlocked (Tr. 2420). When the court told the jury to continue deliberating, the foreman asked that the court explain again the "knowingly" element (Tr. 2424). This time the court reintroduced the recklessness theory and the jury then convicted.

Thus, the last instruction on the law which the jury heard before returning the verdict of guilty was the following excerpt from a portion of the charge the court had initially given:

"While I have stated that negligence or mistake do not constitute guilty knowledge or intent, nonetheless, you are entitled to consider in determining whether a defendant acted with intent or knowingly if he de-

^{*} During the discussion of the court's ruling on requests to charge defense counsel objected when the court indicated that it would grant the government's request for a charge on the concept of reckless disregard. Defense counsel stated:

[&]quot;There are two points I want to make clear on that. One, I think this is not a case of reckless disregard because there is evidence that this was a matter considered by Mr. Natelli and he either knowingly came to a decision it was wrong or not. It wasn't a question of something he disregarded.

The only other thing I would ask you to consider in that portion of the charge is the fact that you are dealing here, in some instances, with unaudited statements" (Tr. 2139-2140).

At the conclusion of the charge defense counsel renewed the exception (Tr. 2383) and repeated this exception when this instruction was repeated after the jury announced they were dead-locked (Tr. 2428).

liberately closed his eyes to the obvious or to facts that certainly would be observed or ascertained in the course of his accounting work or whether he recklessly stated as facts matters of which he knew full well he was ignorant.

"If you find such reckless deliberate indifference to or disregard for truth or falsity on the part of a defendant, the law entitles you to infer therefrom that that defendant wilfully and knowingly filed or caused to be filed false financial information with the SEC. But such an inference, of course, must depend upon the weight and credibility extended to the evidence of recklessness and indifference.

"As stated, ordinary or simple negligence alone would be insufficient to support a finding of guilty knowledge or wilfulness.

"Now, you remember I said a good deal more. * * * " (Tr. 2427)

In light of the record of the jury's deliberations, there can be little doubt that the conviction here rests on this unwarranted and erroneous final instruction that criminal liability could rest on recklessness alone, and that the elements of knowledge and willfulness (as well as of falsity and materiality) could be established by recklessness. This instruction was both unwarranted, in that it had no relevance to the factual issues raised by the indictment and proof, and erroneous, in that it suggested that while "simple negligence alone" would not support a guilty verdict some aggravated form of negligence would, without ever advising the jury that the defendant's action must support the conclusion that he was "conscious" of the fact that he was engaged in wrongdoing. Morissette v. United States, supra.

In order to sustain a conviction for making a false statement to the SEC, the Government must prove that the defendant "knew" the statement to be false. *United States* v. Simon, supra; United States v. Peltz, 433 F.2d 48, 54 (2d)

Cir. 1970), cert. denied 401 U.S. 955 (1971); United States v. Crosbu, 294 F.2d 928, 938-943 (2d Cir. 1961), cert. denied sub nom. Mittleman v. United States, 368 U.S. 984 (1962). While there are circumstances in which one can be held criminally liable for "deliberately closing his eyes to facts" or "recklessly stating as facts things of which he is ignorant", United States v. Benjamin, 328 F.2d 854 (2d Cir.), cert, denied sub nom, Howard v. United States, 377 U.S. 953 (1964), that concept applies only to situations where the defendant's actions evidence "a conscious purpose to avoid learning the truth". United States v. Abrams, 427 F.2d 86, 91 (2d Cir.), cert. denied, 400 U.S. 832 (1970) (Emphasis added); United States v. Sarantos, 455 F.2d 877, 882 (2d Cir. 1972); United States v. Squires, 440 F.2d 859, 864 n. 12 (2d Cir. 1971). See also, United States v. Gottlieb, 493 F.2d 987 (2d Cir. 1974).

Since there was no evidence here that would support a finding that appellant acted with a conscious purpose to avoid learning the truth, it was error to give a "reckless disregard" charge. United States v. Squires, supra. The cases in which an instruction on "reckless disregard" of the truth has been approved involve circumstances in which the accused's professed lack of knowledge of the facts is so strained and his failure to take any steps to learn the true facts so suspicious that the jury would be justified in finding that he actually realized what the true facts were, although as the Court put it in Sarantos he consciously and deliberately blinded himself to those facts. In such a situation the accused is responsible for "knowingly" making a false statement because he has made an unequivocal statement knowing that he had no basis for making the statements at issue as if they were fact. Bentel v. United States. 13 F.2d 327 (2d Cir.), cert. denied sub nom. Amos v. United States, 273 U.S. 913 (1926); United States v. Benjamin. supra.*

^{*} In Benjamin, a certified public accorntant twice published on his letterhead a document entitled "Auditor's Report" making positive statements about the alleged assets of a shell corporation.

But that is quite different from imposing criminal liability here for recklessly failing to realize that the true facts might be otherwise than as stated. The distinction is critical here, because the evidence considered most favorably to the government permitted a conviction—if at all—only under the court's misleading instruction that some level of aggravated negligence would be sufficient. At the time of sentencing, the trial judge underscored this critical basis for the conviction when he observed to both defendants: "I think you are absolutely sincere when you say that you do not believe that you did anything wrong in this audit or audits for National Student Marketing" (A. 284), and then stated:

"But the tragedy is that the jury found that this was an audit or audits done with reckless disregard for what was really involved. We know that because of the record showing what it did in the jury deliberation." (*Ibid.*)

Thus it is clear that the trial judge appreciated that he had allowed the jury to return the conviction on the basis of a finding that the defendants had recklessly failed to realize "what was really involved," not that they had consciously and knowingly closed their eyes to it.

As the judge obviously realized, there was no evidence that Mr. Natelli acted with a "conscious purpose to avoid learning the truth". There are two decisions of Mr. Natelli that were challenged in the indictment: (1) the decision that footnote discussion of the Michaels write-off was not necessary, and (2) the decision not to object to the inclusion of the Eastern commitment in the company's unaudited statement of earnings. The facts surrounding the making of each of these decisions did not justify the submission of the question of Mr. Natelli's knowledge of falsity to the jury on a theory that he acted with "a conscious purpose to avoid learning the truth".

The decision as to the lack of need for footnote discussion of the write-offs did not rest on any ignorance of the

facts and thus cannot be said to involve "a reckless statement of fact of which the narrator is ignorant". Bentel v. United States, supra. Nor can it be said that in this regard that Mr. Natelli acted "with a conscious purpose to avoid learning" whether footnote disclosure was necessary, United States v. Abrams, supra, since he specifically discussed this question with Mr. Otkiss. Thus, there is nothing in the making of this decision which justified the court's giving of the reckless disregard charge.

Similarly, the evidence of the Government's own witnesses contradicts any claim that in determining what position to take on the inclusion of the Eastern commitment, Natelli acted with a "conscious purpose to avoid learning the truth". After being advised of the existence of the Eastern commitment by Randell, Natelli spoke to Dennis Kelly, who provided him with the letter from Eastern Airlines confirming the commitment and a copy of the detailed proposal submitted to Eastern in May. Even after having reviewed these materials, Natelli stated that he wanted additional time to look into the Eastern situation (See testimony of John Buck, Tr. 682). Thereafter Natelli reviewed the time records of the account executive involved and again spoke to Kelly before finally deciding not to object to the company's inclusion of this item in its unaudited statement of earnings for the nine-month Certainly the evidence of Mr. Natelli's action period. with respect to the Eastern contract cannot support a theory that he had "deliberately closed his eyes to avoid knowing whether he was committing an unlawful act". United States v. Brawer, 482 F.2d 117, 127 (2d Cir. 1973).

In addition, it is important to recognize that the ninemonths financial statements were not audited and PMM was not expressing any opinion on those statements. Since neither Mr. Natelli nor his firm were making any statement with respect to the unaudited statements, there was no basis for permitting the jury to rest a conviction on this aspect of the case on a theory that Natelli "recklessly stated as facts matters of which he knew full well he was ignorant". See charge, *supra*, pp. 52-53. Even in the context of civil litigation, it has been recognized that:

"There is, however, no basis in principle or authority for extending an auditor's duty to disclose beyond cases where the auditor is giving or has given some representation or certification." Gold v. DCL, Inc., [1973 Transfer Binder] CCH FedSec.L.Rptr. ¶ 94,036.

Thus, we submit that the facts surrounding each of the false statements alleged in the indictment did not justify the giving of the charge on reckless disregard. The giving of that charge was particularly prejudicial in this case because so much of the Government's evidence was designed to establish that the defendants had earlier been negligent in their work as auditors of NSMC. There is, therefore, a real danger that the jury was led to accept evidence of gross negligence as a substitute for the proof required by the statute-that the defendants act "willfully and knowingly." To permit the court to give a "reckless disregard" charge in a case like this one, thus, dramatically narrows the concept of criminal intent embodied in this statutory language. Morissette v. United States, supra; United States v. Squires, supra; United States v. Fields, 466 F.2d 119 (2d Cir. 1972).

Moreover, even in a case in which a "reckless disregard" charge would be appropriate the trial judge must carefully define for the jury the limited scope of this theory of inferred criminal knowledge by advising them that the defendant can be convicted only if he acted with "a conscious purpose to avoid learning the truth," United States v. Abrams, supra, 427 F.2d at 91 or "deliberately closed his eyes to avoid knowing whether he was committing an unlawful act," United States v. Brawer, supra, 482 F.2d at 127, or "the only reason he did not learn [of the falsity] was because he deliberately chose not to learn for the very purpose of being able to assert his ignorance." United

States v. Olivares-Vega, 495 F.2d 827, 830 n. 10 (2d Cir. 1974). No such instructions were given by the trial judge here to place before the jury the question of the defendant's consciousness of wrongdoing, or the presence of the required criminal intent. Thus, even if the giving of a "reckless disregard" charge was warranted, the charge as given was seriously deficient.

As we noted above, the trial judge concluded from the evidence that appellant sincerely believed that he had done nothing wrong. On that state of facts, Mr. Natelli was entitled to a verdict of acquittal. Here the erroneous charge of the court prevented the jury from reaching that verdict. In these circumstances it is particularly appropriate to recall the warning which this Court recently sounded in *United States* v. Ottley, 2d Cir. Docket No. 74-1731, decided January 7, 1975:

"it is in such a grey area that we must be careful not to 'enlarge the reach of enacted crimes' by unduly narrowing the concept of criminal intent."

See also United States v. Ferrara, 451 F.2d 91, 95 (2d Cir. 1971), cert. denied, 405 U.S. 1032 (1972).

B. The Court Failed to Explain the Differences In an Outside Auditor's Responsibilty for Audited and Unaudited Financial Statements.

The specifications of falsity set forth in the indictment were alleged in two separate paragraphs, one of which related to the audited financial statements for the year ended August 31, 1968 and the other relating to the company's unaudited statements for the nine-month period ended May 31, 1969.*

The court charged the jury:

"Cenerally, as you have been told, in effect, a firm of public accountants, such as Peat, Marwick & Mitchell,

^{*} These statements were specifically labelled "unaudited" in the proxy statement.

engaged to perform an independent audit for a corporation such as NSMC, represents and warrants that it will perform the audit and other accounting work in accordance with generally accepted auditing and accounting principles, that it will render an opinion based upon its audit, for example, as to whether the financial statement of the company fairly presents its financial position and the results of its business operation." (Tr. 2367)

"An auditor must ascertain that the financial statement in question, such as the figures or the footnote fairly present the results of operations and the financial position of the company." (Tr. 2369)

While we do not allege error in this statement as it relates to the auditor's responsibility for audited financial statements, the court never distinguished that responsibility from the auditor's far more limited responsibility with respect to the company's unaudited financial statements.

Even in a civil context the courts have not held outside auditors liable for misstatements in a client's unaudited financial statements where the auditor has not publicly rendered an opinion on those statements. See Fischer v. Kletz, 266 F.Supp. 180 (S.D.N.Y. 1967); Gold v. D.C.L., Inc., supra. As the court said in Seeburg—Commonwealth United Litigation, 72-73 CCH Fed.Sec.L.Rptr. ¶ 93,802 (S.D.N.Y. 1972):

"Accountants have a duty to accurately and fairly review and report the financial condition of the company, but the Court does not believe that *Fischer* or any other case places a duty on them to search out and reveal errors or omissions in management's proxy material for which they have no responsibility as auditors."

Despite defense counsel's request for a charge distinguishing the audited from the unaudited statements

(A. 202-210) and his exception to the charge as given (Tr. 2384), the court refused to advise the jury that the above quoted language applied only when the outside accountant was performing an audit or to explain that an outside accountant has only limited responsibility for a company's unaudited statements.

This error could well have dramatically affected the jury's assessment of Mr. Natelli's actions with regard to the Eastern commitment, which apparently was of major concern to the jury. See pp. 61-63, infra. had heard considerable testimony concerning confirmation procedures employed during an audit. Indeed, the written confirmation procedure followed in the 1969 audit was stressed by the prosecutor in his summation (Tr. 2275). Since the jury was never told that Mr. Natelli's responsibility with relation to the unaudited statements was less than his duty with regard to audited statements, the jury may well have concluded that generally accepted auditing standards required him to obtain an audit confirmation from Eastern Airlines. The error in this regard was particularly prejudicial since the court in giving the "reckless disregard" charge told the jury they could consider whether the defendant had closed his eyes "to facts that would be observed or ascertained in the course of his accounting work".

Thus, while Mr. Natelli did more in reviewing the Eastern commitment than he was required to do on unaudited statements, the jury was erroneously led to believe that his conduct with regard to the company's unaudited financial statements should be judged by the standards applicable to audited financial statements. The court's error in failing to distinguish between audited and unaudited financial statements was, therefore, highly prejudicial and requires reversal. See *United States* v. Casale Car Leasing, Inc., 385 F.2d 707 (2d Cir. 1967).

C. The Court Refused to Correct Vitally Important Misstatements in the Charge Concerning the Eastern Contract and Failed to Respond Properly to a Note From the Jury Indicating that They Had Been Completely Misled by These Misstatements.

Government witnesses Buck and Kurek testified at trial that the first time they heard Randell discuss the Eastern commitment with Natelli was during the early morning hours of August 15th at Pandick Press. The matter was discussed throughout the day on the 15th, and both Kurek and Buck testified that no decision as to the booking of the Eastern commitment was made on the 15th. Buck specifically testified:

"Q. Let me ask you this: At the time you left the printer on that Friday had a decision been made to book the Eastern contract?

A. No.

Q. Isn't it a fact, sir, that Mr. Natelli said he wanted time to look into the matter to satisfy himself that this was a commitment that had been made and that there was a program?

A. That's correct.

Q. And that decision to book that Eastern contract wasn't made until sometime the following week, isn't that correct?

A. Yes, sir." (Tr. 682-683; see also Tr. 541)

Despite this undisputed testimony the court, in summarizing the Government's contentions, twice indicated to the jury that Mr. Natelli immediately agreed to the inclusion of the Eastern commitment at the printers on the 15th (Tr. 2358-2359). When counsel for Mr. Natelli excepted to the charge on the Government's contention as to the Eastern commitment, pointing out that the Court had not even stated the defendant Natelli's contentions on this issue, the Court admitted that there had been an oversight and agreed to inform the jury as to Natelli's contention (Tr. 2381-2382).

Thereafter the Court gave a supplemental instruction on the defendant Natelli's contention that his good faith was established by the evidence that he did not immediately accept the Eastern commitment at Pandick, but went back to Washington and checked the time sheets of the account executives involved and looked into the matter carefully before finally deciding not to object to the inclusion of this item in the company's revenues. The court went on, however, to restate the Government's contentions as follows:

"As you know, the Government says that that evidence isn't persuasive at all. The Government argues that Buck's testimony was that this was really decided at Pandick Press and that Natelli's testimony of his check, into this carefully is not to be believed and was not sufficient to carry the day on this issue." (Tr. 2392)

This statement of the court as to Buck's testimony was totally erroneous, but the court cut short counsel's attempt to bring the transcript of Buck's testimony to its attention (Tr. 2393-2394).

Thus, the jury entered upon its deliberations with a fundamental misconception of the testimony concerning one of the most crucial events at issue. The jury ultimately expressed its confusion on this issue in a note it sent to the court which read:

"Most of us recall that the testimony agrees that Natelli decided to allow Eastern on the morning of the 15th at PanDych (sic) press, that the Figures For Pontiac were left in & only the name was changed. One of us recalls that testimony indicated Natelli didn't decide until days later in Washington, that the Figures were changed as a result, and the Figures were Finally printed after Natelli returned to Washington, not on the 15th.

"Could we hear just enough pertinent testimony about Eastern to clear this up?" (Emphasis added) (Court's Ex. 6)

In response to this note, defense counsel prepared a list of transcript references which focused on the precise issue raised by the jury and demonstrated that the conclusion reached by "most of" the jury was completely wrong and which would have required the reading of approximately 12 pages of transcript (Tr. 2410). The Court refused, however, to follow this approach and instead adopted the Government's suggestion that all evidence relating to the evening at Pandick and all evidence relating to the Eastern commitment be reviewed, including such things as the Government's cross-examination of Natelli as to whether Scansaroli was present when Natelli discussed the Eastern situation with Randell. Thus, instead of hearing "just enough pertinent testimony" to clear up their confusion, the jury heard the rereading of sixty pages of testimony, most of which was not relevant to the question asked and which, taken with the court's erroneous charge, had caused the confusion in the first place (Tr. 2408-2420). Thus, the misconception apparently shared by 11 jurors was never effectively corrected. Cf. United States v. Guglielmini, 384 F.2d 602, 607 (2d Cir. 1967), cert. denied, 400 U.S. 820 (1970).

Moreover, the prejudice to the defendants from the court's inaccurate statement concerning the Eastern commitment and its failure to ensure that the jurors' misconceptions of these events were corrected should not be viewed in isolation. These errors served to compound the error involved in the court's giving of the reckless disregard charge and its failure to discuss the auditor's limited responsibility for unaudited statements. Here as in *United States* v. O'Connor, 237 F.2d 466 (2d Cir. 1956), the conviction should be reversed because

"There is serious doubt that the jury ever understood the issues of the case or the bearing that the complex evidence might have on those issues." D. The Court Erroneously Charged the Jury that in Determining Whether the Audited Statements Were Materially False, They Should Consider the Footnote Alone.

Paragraph 3 of the indictment alleged that the 270-page proxy statement was false and misleading in a material respect because one of the footnotes to the audited statement of earnings for the period ended August 31, 1968, failed to disclose that certain sales and earnings originally reported had subsequently been written off. There was no charge in the indictment that there was an actual overstatement in the sales and earnings figures set forth in the audited statement of earnings. The charge was simply that there was no footnote disclosure of the write-offs that had, in fact, been made. As we have argued in Point I, supra, pp. 42-46, the accuracy of the sales and earnings figures was highly relevant to the determination of whether the lack of footnote disclosure rendered the total financial statement "materially false and misleading".

The charge of the court completely diverted the jury from a consideration of this crucial issue—whether the financial statements as a whole were materially false. The court charged the jury:

"An auditor must ascertain that the financial statements in question, such as the figures or the footnote fairly presents the results of operations and the financial position of the company.

"Perhaps the crucial issue in the case, therefore, can be summarized as follows: Were the quoted earnings figures and footnote set forth in Count 2 fairly set out?" (Tr. 2369)

Since the only earnings figures set forth in Count 2 were those for the unaudited nine-month period and those in the footnote to the audited statements, the jury was being told that as to the audited statement of earnings,

the only question was whether the footnote fairly presented the financial position of the company. At the conclusion of the charge, defense counsel excepted to this portion of the charge on the ground that it directed the jury's attention to the footnote alone, whereas the issue to be considered was whether the audited financial statements as a whole fairly presented the financial condition of the company. United States v. Simon, supra, at 805. Although admitting that the charge may have "telescoped some of this", the court refused to correct or expand upon this instruction (Tr. 2383).

It is clear that the judge's summary of the "crucial issue" was erroneous, since the materiality of any challenged statement must be determined by taking into account all surrounding circumstances and relevant facts including its magnitude in light of the nature and totality of company activity. See, e.g., Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363, 368 (2d Cir.), cert. denied, 414 U.S. 910 (1973); Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540, 551 (2d Cir. 1973), cert. denied, 415 U.S. 918 (1974); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 800 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); Richland v. Crandall, 262 F.Supp. 538, 553 (S.D.N.Y. 1967); United States v. Pope, 189 F.Supp. 12, 23 (S.D.N.Y. 1960).

Moreover, by directing the jury's attention solely to the footnote to the audited financial statements without placing that footnote in the overall context of the total audited financial statements, the court distorted the professional accountant's view of the matter and completely undercut the whole theory of the defense on this issue. Throughout the trial the Government repeatedly focused attention on the fact that the footnote was inaccurate because the write-offs of the Michaels contracts were not reflected on

the line of the footnote relating to the company "Originally reported", but were subtracted from the line entitled "Pooled companies . . .". Mr. Natelli explained, however, that once he and Mr. Otkiss determined that, given the changed circumstances of the company, the Michaels write-offs were not material and disclosure was not necessary, the logical place to make the adjustments in that particular footnote was in the line reflecting the adjustments from the figures originally reported. Mr. Natelli conceded that the title on that line should, however, have been changed to read "Pooled companies and adjustments" (Tr. 1913).

Since Mr. Natelli readily conceded that the footnote was not literally accurate, the court's instruction to the jury that they were to consider whether "the footnote fairly presents the results of operations and the financial position of the company' was devastating to his defense. The purpose of the footnote at issue was not to present the "results of operations . . . of the company". That was the purpose of the statement of earnings which the SEC staff accountant testified accurately reflected the write-offs that had occurred (Tr. 1291, 1294-1296). The purpose of the particular footnote at issue was merely to indicate the trend of earnings as between the original company and the pooled companies (Tr. 1363), and for this limited purpose the adjustments were not material since the net effect on earnings was only \$21,000. See Escott v. BarChris, supra. 283 F.Supp. at 681.

Thus, this error in the court's charge completely diverted the jury from a proper assessment of an essential element of the Government's case—whether the audited financial statements taken as a whole were materially false and misleading. Since this error resulted in the court's failing to fulfill its essential function of presenting the defense's theory to the jury, the resulting conviction should be reversed. United States v. Smith, 230 F.2d 935 (6th Cir. 1956).

E. The Court Erred In Not Instructing The Jury That It Must Find That Defendant Knew That The Alleged Misstatements Were Material.

The trial court also failed to instruct the jury clearly that, if it should find that the footnote was materially false in terms of the invertment judgment of a reasonable investor, it would then have to consider the different question of whether the defendants knew of the alleged materiality. The defendants might negligently have differed in their judgment from that found to be the judgment of the "reasonable investor"—the reasonably prudent man of this case—but such assumed negligence would not by itself replace the guilty knowledge the statute and the indictment required.

Section 32(a) of the Securities Exchange Act of 1934 requires that the misstatement, which is the basis of the crime, be "willfully and knowingly" made and that it be "false or misleading with respect to any material fact." There is no distinction between the elements of falsity and materiality; knowledge must be found as to both. See also Securities Act of 1934 § 23(a), 15 U.S.C. § 78w(a); Reg. S-X, Rule 3-02, 17 C.F.R. § 210.3-02 (1974).

The charge to the jury dealt very specifically and at some length with the question of materiality in terms of an objective definition of materiality—a reasonable investor test. The charge in this regard was the following:

"Now, I have been talking about material facts. You heard material facts being discussed by lawyers and witnesses during the trial. I want to define here for you what the law means about material facts.

"Let me approach it for you in this way. In deciding whether a fact is material, ladies and gentlemen of the jury, you are entitled to consider whether it was the kind of information that a financial statement ordinarily contains in order to fulfill its function of fairly presenting the financial picture of the company for which it is filed.

"A material fact can be simply defined as one that would matter to a reasonable person in deciding whether or not to purchase NSMC's stock, for example. That is to say, a fact, the validity of which would concern a reasonable person in making his purchase or investment decision.

"Obviously a balance sheet or income statement is not supposed to contain all the information a creditor or potential investor or stockholder might need or want to know in order to make informed judgments. The function of the financial statement is simply to present a basic summary of the company's financial position and operations and earnings for the time period stated." (Tr. 2368-69).

Although we do not challenge this statement of the objective test of materiality, the court never clearly instructed the jury on the need for a specific finding that the defendant believed the statement to be materially false.

The court, both in its response to the jury's request of what was meant in the statute by the term "knowing", and in its original instruction on knowledge, charged the jury as follows:

"In the context of this case, ladies and gentlemen a defendant may be found to have acted wilfully and knowingly only if he knew that a portion of the financial statement, such as a footnote or some other entry was false and misleading." (Tr. 2426; see also Tr. 2363).

This instruction did not inform the jury that before it could convict, it would have to find that defendants knew that the alleged misstatements were material.

While the charge did contain some passages containing language such as "an intention to include false and misleading information of a material nature is required" (Tr. 2364), this rather ambiguous language was contradicted by

other portions of the charge. For example, immediately after the just quoted language, the court continued "Good faith, that is to say an honest belief in the truth of the data set forth . . . would constitute a complete defense here".* Since it was conceded that the footnote was not literally true, this language seriously undercut Mr. Natelli's defense that the decision to drop the Michaels and tax adjustments into the line with the adjustments coming from the pooled companies was based on the conclusion he and Otkiss made that given the net \$21,000 effect on the bottom line, these items were not material.

The decision which Natelli and Otkiss made as to the materiality of the items in question are not peculiar to this

* That other isolated segments of the charge could be construed as instructing the jury that they must make a finding that the defendant knew the false statements were materially false, cannot negate the fact that the above-quoted passages clearly indicated to the jury that only an objective finding of materiality was required. This is particularly so since these isolated segments were often contradicted by other portions of the charge.

Thus, the court charged:

"On the other hand, should you find that the quoted material is substantially inaccurate and misleading in whole or in part, then you would have to turn your attention to each of the defendants to consider what the evidence shows that he did or failed to do and to determine whether or not he participated in a scheme to knowingly and intentionally permit the submission of earnings figures known to be false in a material way to the SEC in the proxy statement." (Tr. 2370).

However, the thrust of this statement was dissipated when, only moments later, the court said:

"If you find that a given defendant participated simply through careless necessity or negligence, with a mistaken but nevertheless honest belief that his participation was correct, truthful and sufficient, then you should acquit that defendant." (Tr. 2371)

Thus, once again the jury was thrown back to the issue of objective truthfulness. (See also Tr. 2363, 2400, 2426).

Viewing the charge as a whole, as it must be, it cannot be said that the jury was clearly instructed on this vital issue. case. The practice of the profession of accountancy continually involves repeated judgments as to materiality. Judgments of this nature are not only consistent with the SEC's accounting regulations (Rule 3-02 of Regulation S-X), but are an essential element of the substantive pronouncements of the profession. See, e.g., AICPA, Auditing Standards and Procedures—Statements on Auditing Procedure No. 33 at 17 (1963). Thus, under APB, Accounting Principles § 510.09 (1968) which was applicable at the time of the events in question, the governing rule was that the ordinary principles "have application only to items material and significant in the relative circumstances. . . . [I] tems of little or no consequence may be dealt with as expediency may suggest."

In this case it was critically important in connection with the challenged footnote that the jury be properly instructed that knowledge of materiality, as well as of falsity, was an essential element. Concededly, the challenged footnote did not specifically disclose the write-off of the Michaels commitments and Natelli knew it did not. The issues then were whether the omission was material and whether Natelli knew it to be so. The jury was only instructed concerning the first of these two issues.

The jury was diverted, in determining whether Natelli acted with the requisite culpability, from weighing the factors which permitted Natelli to reach the good faith judgment that the omission was not material:

- (1) The sales and earnings figures in the summary of earnings itself were accurate, and the reversal of the deferred tax liability was shown there as an extraordinary credit.
- (2) An authoritative pronouncement of the accounting profession treated a footnote of this nature as a matter relating to earnings, not to sales.
- (3) The impact of the write-offs on earnings was only \$21,000, an inconsequential amount.

- (4) Michaels, whose wrongdoing had apparently caused the problem, was no longer with NSMC. Adequate explanation of the write-offs seemed to require, however, pointed and possibly defamatory description of the conduct in question.
- (5) Income from fixed-fee sales was, at that time, being accrued only if evidenced by a firm written commitment in a form agreed upon between NSMC and PMM, and NSMC's experience with written commitments had been good (Gx. 15 & 16).
- (6) As the result of a number of acquisitions, NSMC's business had been substantially changed and enlarged since August 31, 1968 and thus, the fixed-fee programs had become a much less significant element of NSMC's business.
- (7) Natelli's judgment was concurred in by his partner, Mr. Otkiss.

The total effect of the charge was that it eliminated from consideration by the jury Natelli's defense of honest professional judgment as to materiality.

We recognize that no exception was taken to this portion of the charge in the court below, although a charge on knowledge of materiality was requested (A. 226-227, Tr. 2145-46). This was, moreover, a close case, and this error was one of several that went to the central issue of whether the defendant acted with a culpable state of mind. Thus, despite the lack of objection below, it is appropriate to find "plain error" in this portion of the charge on the essential element of knowledge that the statements at issue were materially false. United States v. Garguilo, 310 F.2d 249, 254 (2d Cir. 1962).

F. The Court Failed to Charge the Jury that They Must Be Unanimous As To The Particular Specification of Falsity.

After noting that the single count on trial had specified two separate portions of the proxy statement as being false and misleading, the court said:

"Now, I instruct you that if you find that the proxy statement was false in either one of these two respects that is sufficient to support a conviction." (Tr. 2340)

While this statement is in itself correct, it is insufficient. The court erred in refusing counsel's request that it advise the jury that in order to convict, they must be unanimous on which, if either, of the two specifications had been proven materially false beyond a reasonable doubt (Tr. 2384). Thus, the charge of the court left the jury free to convict if only six of them believed the proxy statement to be materially false in one respect but the other six believed the proxy statement to be materially false in the other respect. This was clearly improper for as the Supreme Court stated in Andres v. United States, 333 U.S. 740, 748 (1948):

"Unanimity in jury verdicts is required where the Sixth and Seventh Amendments apply. In criminal cases this requirement of unanimity extends to all issues—character or degree of the crime, guilt and punishment—which are left to the jury."

Thus, even if the court were to conclude that the evidence was sufficient to warrant the submission of each of the allegedly false statements to the jury, the conviction still can not stand, since it cannot be determined whether the jury did in fact unanimously agree on a single specification of falsity. Cf. United States v. Adcock, 447 F.2d 1337 (2d Cir.), cert. denied, 404 U.S. 939 (1971).

G. The Court Gave A Charge On A Theory Of Motive Not Supported By The Evidence Or Even Argued By The Government.

After advising the jury that the defendants' lack of motive was relevant on the issue of knowledge and intent since people do not generally engage in criminal conduct unless they have a motive, and pointing out that there was no evidence that either defendant personally profited from their alleged misconduct, the court told the jury:

"However, the prosecution argues that there were some substantial human motives outside of direct material gain for the conduct of both defendants. For example, as you know, the Government argues that the defendants were well aware that PMM and their own local office of PMM had acquired what looked like a very promising retainer, that of NSMC, and that this retainer looked like it would be an important and perhaps profitable one, and that the defendants were well aware that they were performing a substantial role for their own firm in servicing this retainer and that they were very anxious to assist management, even to the point of aiding and abetting management in filing false earnings figures with the Securities and Exchange Commission." (Tr. 2372-2373)

This instruction was completely erroneous since there was no such evidence and the Government had made no such argument. Yet despite counsel's protests, the court refused to correct this portion of the charge (Tr. 2385-2387). Compare *United States* v. *DeAngelis*, 490 F.2d 1004 (2d Cir.), cert. denied, 94 S.Ct. 1970 (1974).

There can be no question that, as the court did charge, lack of a motive for alleged criminal conduct is highly relevant to an assessment of the defendant's contention that he did not knowingly engage in criminal conduct. See *United States* v. *Simon, supra* at 808-810. Thus, it was clearly prejudicial for the court in its charge to sug-

gest to the jury for the first time a theory of motive on which no proof had been offered. Since the Government had offered no proof as to the fees paid to PMM by NSMC, there was no occasion for Mr. Natelli to offer any evidence to show how comparatively minor the NSMC fees were to the overall income of PMM or that, as a partner, his personal income was computed as a percentage of the overall income of his firm. Thus, although the theory of motive erroneously described by the court could easily have been answered, appellant never had an opportunity to do so because it was made for the first time in the charge of the court.

We do not question the right of the trial judge to comment on the evidence. But as Chief Justice Hughes noted in *Quercia* v. *United States*, 289 U.S. 466, 470 (1933):

"This court has accordingly emphasized the duty of the trial judge to use great care that an expression of opinion upon the evidence 'should be so given as not to mislead, and especially that it should not be one-sided'; that 'deductions and theories not warranted by the evidence should be studiously avoided.' Starr v. United States, 153 U.S. 614, 626, 14 S.Ct. 919, 923, 38 L.Ed. 841; Hickory v. United States, 160 U.S. 408, 421-423, 16 S.Ct. 327, 332, 40 L.Ed. 474. He may not charge the jury 'upon a supposed or conjectural state of facts, of which no evidence has been offered.' United States v. Breitling, 20 How. 252, 254, 255, 15 L.Ed. 900." (Emphasis added).

See United States v. Fernandez, 480 F.2d 726, 738 (2d Cir. 1973).

Since no evidence had been offered by the Government to support the theory of motive propounded by the judge, and lack of motive was such an important element in this case, this portion of the charge alone requires reversal. In Point I, we demonstrated that the Government's evidence was not sufficient to sustain the conviction. Even if the Court were to find the evidence was sufficient, there can be little question that this was a close case. As this Court recognized in *United States* v. *Garguilo*, 310 F.2d 249, 254 (2d Cir. 1962):

"The closeness of the issue against [the defendant] imposed an obligation on the trial judge to instruct the jury with extreme precision, . . . and on us to review the charge with what, in a less doubtful case, would be undue meticulousness."

See also, *United States* v. *Grunberger*, 431 F.2d 1062, 1069 (2d Cir. 1970).

Judged against this standard, the charge as given was seriously deficient and the resulting conviction can not stand.

POINT III

Evidence of a good faith error in computing the deferred tax credit was improperly received as proof of fraud.

The audited financial statements for the period ending August 31, 1968 printed in the proxy statement reflected as an extraordinary credit "Reduction of deferred tax provision as a result of net operating loss carry forwards... [\$]188,750." The effect of this tax credit was to increase the company's net earnings for that period by \$188,750.

The indictment did not challenge the appropriateness of this tax credit. Indeed, as noted at various places above, the indictment did not allege that the earnings for the period ending August 31, 1968 were overstated in any respect. It alleged solely that there was no footnote treatment of the write-offs that had been made. The lack of such an allegation in the indictment was significant since it was known as far back as 1970 that PMM had made an error in the spring of 1969 when it determined that the \$190,000 provision for deferred taxes in the original audited financial statements for the year ended August 31, 1968 was unnecessary. Thus, while the proxy reported an extraordinary tax credit of \$188,750, it was discovered in January or February, 1970 that because of a failure to recognize one of the timing differences between financial statement accounting and tax accounting, the actual tax reduction should only have been about \$90,600.

Despite the fact that the Grand Jury had obviously concluded that a mistake in this rather complex area of accounting had been made in good faith, at the very end of its case the Government introduced Mr. Natelli's testimony in the SEC private investigation, in which he acknowledged that this error had been made, as the sole proof from which it intended to argue that "this tax credit is a fraud." (Tr. 1332) A review of the circumstances leading up to government counsel's introduction of this "admission", as well as the available evidence, demonstrates that the government counsel's contention that this was "a fraud" was not bona fide and this highly prejudicial evidence should not have been admitted.

Prior to trial, the Government submitted to the court a memorandum of law indicating that at trial it intended to read into evidence portions of the grand jury testimony of Natelli and Scansaroli relating to the lack of footnote treatment of the write-offs of the commitments originally accrued at August 31, 1968. In this grand jury testimony, both Scansaroli and Natelli stated that one of the factors leading to the conclusion that footnote treatment of the contract write-offs was not necessary was that the \$188,750 retroactive adjustment to deferred taxes was also being made, and the net effect on earnings of these two retroactive adjustments was only \$21,000. Counsel for the government did not suggest, however, either in the pre-trial

memorandum or at the time he offered this testimony on the seventh day of trial, that there was any question that the defendants honestly believed that a tax credit of \$188,750 was required, or that he intended to offer any other testimony of the defendants.

One week later, on the day it had announced it would rest its case, the Government for the first time advised the court that it wished to read into evidence portions of the SEC testimony of each of the defendants. In this testimony, each of them stated that several months after the proxy was prepared, they had occasion to review the calculations of the deferred tax credit and they determined that an error had been made in the spring of 1969, and that the credit should have been only approximately \$90,000.

When defense counsel objected that there was no evidence that this was anything other than an honest error, counsel for the Government argued: "We think this tax credit is a fraud" (Tr. 1332). Although the court noted that the Government was "injecting an entirely new note into the case" (Tr. 1333), the Government was permitted to read this testimony to the jury (Tr. 1373). The Government then rested without introducing any evidence that the tax calculation was, as it claimed, a "fraud".

The Government's failure to offer such proof of "fraud" in the original determination of the tax credit is particularly significant. Prior to trial, government counsel had interviewed Mrs. Raimondo, the PMM tax specialist, who ultimately testified as a defense witness that she was the person who determined that substantially all of the \$190,000 of deferred taxes originally provided at August 31, 1968 should not have been provided (Tr. 1390). Her testimony was corroborated by the contemporaneous memorandum she prepared in the spring of 1969 which stated:

"Note possible deferred tax liability problem. Paragraph 44 of Opinion 11 would seem to indicate that the

large deferred tax liability was not necessary." (Tr. 1381-1390; Natelli Ex. O)

Despite its claims of "fraud", the Government did not ask Mrs. Raimondo a single question designed to impugn her testimony that she made an honest decision in the spring of 1969 that substantially all of the \$190,000 provision for deferred taxes originally accrued at August 31, 1968 should not have been provided.

Also significant as to the lack of bona fides of the Government's argument that "this tax credit is a fraud" is the fact that the portion of Scansaroli's testimony which was read indicated that when this error was discovered in January, 1970, he discussed the matter with Kurek, the chief government witness. Yet, neither Kurek nor any other government witness had been asked a single question on this issue.

During his testimony at trial, Mr. Natelli explained that in January of 1970, it was discovered that an error had been made in May, 1969 because the PMM personnel involved did not take into consideration one of the items in the financial statements that would give rise to a deferred tax liability. He explained that NSMC, for financial statement purposes, deferred a substantial amount of expenses it had incurred on the "per inquiry" programs and that these charges would be expensed in the financial statements during the subsequent period to match the income coming in from those programs. Although these charges were deferred for financial statement purposes, they were immediately taken as expenses for tax purposes and this timing difference was overlooked in May when they determined that substantially all of the original \$190,000 of deferred tax provision was not needed (Tr. 2119-2121).

Mr. Natelli also testified that when this error was discovered in January, 1970, it was discussed with Kurek, but again the Government made no effort to recall its principal witness to dispute Natelli's testimony or otherwise prove its claim of "fraud".

Undaunted by Mrs. Raimondo's unequivocal and unchallenged testimony and his own failure to introduce any evidence that the determination of the amount of the deferred tax credit was anything other man a good faith error, counsel for the government argued in summation:

"The Government contends . . . that that tax credit is a phony." (Tr. 2316).

Since the indictment did not allege that the tax credit was a "phony", the Government could not amend the indictment to encompass such a charge not made by the grand jury. Russell v. United States, 369 U.S. 749 (1962); Stirone v. United States, 361 U.S. 212 (1960); Ex parte Bain, 121 U.S. 1 (1886). Thus, the only possible basis on which the Government could seek to justify the admission of this evidence is on the theory that it was other criminal conduct of the defendants relevant on the concededly crucial issues of knowledge and intent.

But in order to utilize evidence of other misconduct for such a purpose the Government must offer convincing proof that the defendant deliberately and consciously engaged in such misconduct. United States v. Brettholz, 485 F.2d 483 (2d Cir. 1973), cert. denied, 415 U.S. 976 (1974). Here the government did not support its offer of the defendants' SEC testimony concerning the tax error with any evidence, let alone convincing evidence, that "this tax credit is a fraud". Evidence of other crimes is not admissible if it is "of vague and uncertain character", United States v. Spica, 413 F.2d 129, 131 (8th Cir. 1969); United States v. Clemons, 503 F.2d 486 (9th Cir. 1974); cf. United States v. Byrd, 352 F.2d 570, 575 (2d Cir. 1965). As the Court held in United States v. Clemons, supra at 490:

"Where [other criminal] conduct is to be admitted to show knowledge and intent, the proof must be complete enough and the fact situation proved must clearly warrant a jury finding that the . . . conduct was intentional or knowing."

POINT IV

Polygraph testimony should have been received on the issue of lack of knowledge and willfulness.

Prior to trial, both appellants moved in the alternative for (1) the admission into evidence of expert testimony from a polygraph examiner who had administered liedetector tests to appellants, or (2) for a hearing on the reliability of polygraph evidence, or (3) for court appointment of an independent expert to administer polygraph tests.

In support of this motion, appellants submitted an affidavit from Richard O. Arther, a nationally recognized polygraph expert, who had examined both appellant Natelli and his co-defendant Scansaroli, and determined that each of them was telling the truth when they said that they did not know the NSMC financial statements in the proxy statement were false and misleading. Mr. Arther, who is the author of over 175 articles on the use of the polygraph and who has personally given basic polygraph training to over 1000 people from various law enforcement agencies throughout the country, also attested to the reliability of the polygraph examination and to its burgeoning use by law enforcement agencies, including the F.B.I., the Postal Service, the Treasury Department, and all branches of the military (A. 40-45).

The district court denied the motion in all respects, noting simply that "lie detector evidence has never been admitted at trial in this Circuit" (A. 51-52). Under all the circumstances of this case, the refusal to consider this evidence was erroneous.

Perhaps the case most frequently cited for the proposition that polygraph evidence is not admissible in a criminal trial is *Frye* v. *United States*, 293 Fed. 1013 (D.C.Cir. 1923). But the decision in *Frye* was based on the existing state of the science of polygraph testing over fifty years

ago, and the court expressly recognized:

"* * * Just when a scientific principle or discovery crosses the line between the experimental and demonstrable stages is difficult to define. Somewhere in this twilight zone the evidential force of the principle must be recognized, and while courts will go a long way in admitting expert testimony deduced from a well-recognized scientific principle or discovery, the thing from which the deduction is made must be sufficiently established to have gained general acceptance in the particular field in which it belongs."

This Court has not had occasion in recent years to consider the scientific reliability of polygraph examinations, but we submit that the affidavit of Mr. Arther in the record here and recent federal and state case law indicate that, under the Frye standard, polygraph evidence has come of age.* At least two federal courts have been convinced, after detailed pre-trial hearings, that polygraph evidence is sufficiently reliable to be admissible. See United States v. Ridling, 350 F.Supp. 90 (E.D.Mich. 1972); United States v.

^{*} The cases in this Circuit that were cited to the court below as not authorizing the use of polygraph evidence dealt only summarily with the issue and did not follow any evidentiary hearing on the question. In United States ex rel. Sadowy v. Fay, 284 F.2d 426 (2d Cir.) cert. denied, 365 U.S. 850 (1960), aff'g 189 F.Supp. 150 (S.D.N.Y.), the issue was presented in the context of a habeas corpus petition by a state prisoner, and this Court held only that the New York state rule excluding such evidence was not shown to violate the Due Process Clause. Judge Kaufman's decision in United States v. Stromberg, 179 F.Supp. 278 (S.D.N.Y. 1959), was rendered more than fifteen years ago, before the scientific basis for polygraph examinations became generally established and before business and Government began to utilize the polygraph on a broad scale as a reliable personnel tool. Significantly, moreover, this Court in Fay, supra, eschewed any immutable statement on the admissibility of polygraph evidence, noting that an earlier state court's acceptance of such evidence "may well be prophetic of the general recognition which the courts may ultimately accord to lie detector tests." 284 F.2d at 427

Zeiger, 350 F.Supp. 685 (D.D.C.), rev'd per curiam, 475 F.2d 1280 (D.C.Cir. 1972), cert. denied, 412 U.S. 907. In addition, the Ninth Circuit, in *United States* v. DeBetham, 470 F.2d 1367, 1368 (1972), noted that the evidence adduced at the district court hearing in that case "vigorously supports the accuracy of polygraph evidence."

Of particular relevance here is the well-reasoned opinion in *Ridling*, where the court held that polygraph evidence was admissible on the same elements for which appellants Natelli and Scansaroli tendered it. The key issue at the trial in the present case was whether the defendants "willfully and knowingly" assisted in the preparation of a false and fraudulent proxy statement. In *Ridling*, the defendant was charged with perjury, which also required a finding that the false testimony was given "willfully" and "knowingly." The court explained why it was convinced that polygraph evidence was appropriate on those issues:

"At the beginning it must be noted that this, among all possible cases, is the best case for testing the admissibility of polygraph testimony. A perjury case is based on 'willfully' or 'knowingly' giving false evidence. The experts all agree that the polygraph examination is aimed exactly at this aspect of truth. A subject, they say, may be honestly mistaken as to a fact and, if he answers according to his honest belief, the

[•] The district court's decision in Zeiger was reversed summarily by the District of Columbia Circuit under a unique provision of the District of Columbia Code allowing interlocutory appeals by the Government during trial from adverse rulings on evidentiary questions. Full briefing of the issues was not available at the appellate level because of the expedited nature of the proceeding, which required that such interlocutory appeals be heard within 48 hours of the district court's decision and disposed of within an additional 48 hours. See 23 D.C. Code § 104(d), (e). Furthermore, that statute provides that an interlocutory appellate decision in favor of the Government does not prevent the defendant from contending, on appeal from any subsequent conviction, that the exclusion of his proffered evidence was error.

operator will interpret the results as being a truthful answer" (350 F.Supp. at 93, emphasis added).

In so holding, the court was careful to point out that such evidence was admissible, in part, because it went to the heart of the case. The utility of polygraph evidence in other kinds of criminal cases was seen as more limited. As a precaution against fraud or mistake, the use of court appointed experts was required. The *Ridling* decision thus carves a sensible, circumspect, and fair exception to prior precedent.

Numerous recent cases suggest that, where a defendant persuades the trial court that polygraph evidence has met with sufficient acceptance, and that its admission is appropriate to the issue at hand, he should be entitled to its admission upon a proper foundation, or at least to have the trial judge exercise independent discretion on the issue.** As the Fifth Circuit recently put it, there is a

[•] See also, Note, *Pinnochio's New Nose*, 48 N. Y. U. L. Rev. 339, 363, n. 134 (1973), noting the particular relevance of polygraph evidence in situations like the present one:

[&]quot;* * Polygraph evidence relating to other charges involving an element of knowing falsification, such as fraud, forgery or falsifying accounts, would have equally high relevance."

^{**} United States v. Pacheco, 489 F.2d 554, 566 (5th Cir. 1974), U.S. App. Pndg. 43 U.S.L.W. 3039 (U.S. Apr. 13, 1974); United States v. Francis, 487 F.2d 968, 972 (5th Cir. 1973), cert. denied, 94 S.Ct. 1615 (1974); United States v. DeBetham, supra, 470 F.2d 1367, aff'g per curiam, 348 F.Supp. 1377 (S.D. Calif. 1972); United States v. Chastain, 435 F.2d 686, 687 (7th Cir. 1970); United States v. Wainwright, 413 F.2d 796, 802-803 (10th Cir. 1969), cert. denied, 396 U.S. 1009 (1970); United States v. Tremont, 351 F.2d 144, 146 (6th Cir. 1965); United States v. Lanza, 356 F.Supp. 27 (M.D. Fla. 1972).

See also Commonwealth v. A. Juvenile (No. 1), 15 Crim.L. Pep. 2323 (Mass.Sup.Jud.Ct. June 12, 1974); State v. Stanislawski, 15 Crim.L.Rep. 2093 (Wis.Sup.Ct. April 4, 1974); State v. Alterete, 15 Crim.L.Rep. 2028 (N.Mex.Ct.App. February 27, 1974). See also, People v. Cutter, 12 Crim.L.Rep. 2133 (Sup.Ct.Calif. November 6, 1972), appeal abandoned by Dist. Atty., 14 Crim.L. Rep. 2420 (February 27, 1974); Walther v. O'Connell, 72 Misc.2d 316, 339 N.Y.S. 2d 386 (Civ.Ct.Queens 1972).

discernible trend "towards loosening the restrictions on polygraph evidence," *United States* v. *Frogge, supra*, 476 F.2d at 970.* This trend reflects the current acceptance by criminal justice experts of the reliability of polygraph evidence.**

POINT V

Under the circumstances of this case, the Court should order dismissal of the indictment as a sanction for the deliberate misconduct of a senior Government official involved in this prosecution.

On the sixth day of trial, mid-way through the Government's case, counsel for defendant Natelli brought to the attention of the trial judge an article that had appeared in the Wall Street Journal the previous day, October 29, dealing with the case (Tr. S35; Court Ex. 1). The article spanned virtually the entire page and was headlined: "Fraud Trial of Peat Marwick Attracts Anxious Attention of Other Accountants." The article stated that this case was "a test case in the government's effort to enforce securities laws against auditors and lawyers" and quoted a Washington source as stating: "If we can't get a conviction here, we never will."

^{*} Rule 702 of the new Federal Rules of Evidence sets forth the controlling standard in deliberately broad language:

[&]quot;If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise."

See generally, *United States* v. Stifel, 433 F.2d 431, 438 (1970), cert. denied, 401 U.S. 994 (1971).

graph ("L' Detector") Technique (1966). Note, The Emergence of The Polygraph at Trial, 73 Colum.L.Rev. 1120 (1973); Note, Pinnochio's New Nose, 48 N.Y.U.L.Rev. 339 (1973); Wicker, The Polygraph Truth Test and the Law of Evidence, 22 Tenn.L.Rev. 711 (1953); compare, Inbau & Reid, Lie Detection and Criminal Interrogation (3rd ed. 1953).

The judge recognized that "this kind of statement by any representative of the Justice Department or perhaps of the SEC would be a serious breach of the Justice Department Guidelines on free press-fair trial matters" and instructed the prosecutor to determine the source of the comment (Tr. 838). Several days later, the Government submitted a memorandum (Court Ex. 3) from the Chief Accountant of the Securities and Exchange Commission. John C. Burton. In this memorandum Burton confessed that ten days before the trial, he had given an interview to the Wall Street Journal reporter covering the trial. Mr. Burton stated that the reporter raised with him the Four Seasons trial* and in that context, they discussed this case. Mr. Burton admitted that the quotation that appeared in the article, if not his exact words, "was certainly consistent with the sense of a conversation I had with [the Wall Street Journal reporter]" (Tr. 1182-1183).**

Both defendants moved for a dismissal of the indictment because of the Government's deliberate generation of prejudicial publicity in violation of applicable court rules and Government regulations (Tr. 1634). In seeking an opportunity to examine Mr. Burton at a hearing, defense counsel advised the court that earlier, after the return of the indictment in this case, Mr. Burton had made a speech in which he stated that he would not have referred these

^{*}Three months earlier, the same reporter had written an article noting that after the unsuccessful prosecution in the Four Seasons case of three Arthur Andersen & Co. accountants the senior partner of that firm had sharply criticized the SEC and its senior officials. Wall Street Journal, July 12, 1974, p. 1.

^{**} In order to avoid generating any further newspaper stories about the sensitive publicity issues, most of the proceedings dealing with this question were separately transcribed and not typed or filed until after the trial. See Transcript of Nov. 5, 6, 7, 8, 1974 (Tr. 2437-2459). Articles in the *Journal* dealing with excluded evidence (Court Ex. 2; Tr. 1139) and with the effort to ascertain the source and impact of the prejudicial comment (Court Exs. 4 & 4a, Tr. 2457-2458) were a problem throughout the trial.

cases to the Department of Justice if these people were not guilty and further represented to the court that Mr. Burton had previously made a similar comment to the press about a pending civil suit and had been advised by Peat, Marwick's general counsel that public comments on pending litigation were improper (Tr. 2441).

Thereafter, at defense counsel's suggestion, the judge individually asked the jurors, in the absence of counsel, whether they had seen or heard any media publicity about the case during the trial (Tr. 2445-2454). The foreman responded: "There is a young lady on my job who wanted to tell me what she read in the Wall Street Journal, but I told her not to tell me" (Tr. 2445). The judge did not inquire further whether the co-worker in fact conveyed the tone or substance of the article. Juror number 3 said she had not seen or read any reports, "but I understand from my father that it has been in the paper" (Tr. 2447); again, no questions were put to ascertain whether the substance and thrust of the article had been conveyed to her. Juror number 4 candidly answered:

"No, I didn't see anything. I was anxious to look but I couldn't see nothing" (ibid.).

The judge did not pursue the juror's concession.

After the jury returned its verdict on November 13, the court denied the motion to dismiss, holding that there was no evidence that the article had "infected" the jury (Tr. 2434).

The constitutional right to a fair trial before an impartial jury is the subject of protection by several applicable codes that expressly prohibit the kind of statement made here by the SEC's Chief Accountant—an expression of belief in the accused's guilt. Thus, the Justice Department regulations instruct in pertinent part (28 C.F.R.

§ 50.2(b)):

- (6) The release of certain types of information generally tends to create dangers of prejudice without serving a significant law enforcement function. Therefore, personnel of the Department should refrain from making available the following:
- (vi) Any opinion as to the accused's guilt, . . . Similarly, District Court Local Rule 8 directs in pertinent part:

"During the trial of any criminal matter, including the period of selection of the jury, no lawyer associated with the prosecution or defense shall give or authorize any extrajudicial statement or interview, relating to the trial or the parties or issues in the trial, for dissemination by any means of public communication, except that the lawyer may quote from or refer without comment to public records of the court in this case."*

These formal restrictions are in part the outgrowth of cases like Sheppard v. Maxwell, 384 U.S. 333 (1966), in which the Supreme Court explained the duty of the judiciary to be zealous and creative in taking "those remedial measures that will prevent prejudice at its inception . . ." 384 U.S. at 363. In Sheppard, the Court reversed a state murder conviction because the trial court had failed to prevent persons connected with the prosecution from making extrajudicial statements "which divulged prejudicial matters" such as ". . . any belief in guilt or innocence; or like statements concerning the merits of the case."

^{*} See also, American Bar Association Code of Professional Responsibility, Disciplinary Rule 7-107(B)(6) (1971); American Bar Association Project on Standards for Criminal Justice, Standards Relating to Fair Trial and Free Press, § 1.1(b)(1968) (hereinafter "ABA Fair Trial Standards").

Although Mr. Burton was not a member of the Department of Justice at the time, he was a high official—the Chief Accountant—of the federal agency that was directly involved in bringing and conducting this criminal prosecution, and his misconduct must be imputed to the Government. See Giglio v. United States, 405 U.S. 150, 154 (1972); United States v. Deutsch, 475 F.2d 55, 57 (5th Cir. 1973); United States v. Bryant, 439 F.2d 642, 650-51 (D.C. Cir. 1971). Indeed, the Attorney General has stated in a publicly released "Memorandum to the Heads of All Executive Departments, Agencies and Independent Establishments Re Press Releases and Other Public Statements Concerning Litigation Being Conducted by the Department of Justice," dated September 17, 1974:

The public comment of other agencies concerning prospective or pending litigation has been deemed by the courts to be subject to the same scrutiny as the statements of attorneys and other officials in the Department of Justice directly responsible for the litigation.

Imposing a sanction in this case because of the deliberate violation of this prohibition by the SEC Chief Accountant is particularly appropriate.* As Chief Accountant, he was one of the most senior Government officers concerned with the investigation and prosecution of this matter and his agency not only referred this case to the Department of Justice, but also participated directly and substantially in the preparation and trial of the case itself (Tr. 24, 33, 1155-1376, 2321).**

^{*} The SEC regulations defining the authority of the Chief Accountant is found at 17 C.F.R. § 200.22 (1974).

^{**} The SEC's special interest in the outcome of this criminal prosecution is made even more clear by the fact that the Commission has pending a related civil suit seeking an injunction against Peat Marwick and the defendants Natelli and Scansaroli and others. The complaint asserted violations of Rule 10b-5 in connection with allegedly false statements contained in the NSMC August 1969 proxy statement. See SEC v. National Student Marketing Corp. vition (D.D.C. Civ. No. 225-72).

The court below denied the motion to dismiss because there was no proof that Chief Accountant Burton's statement had actually "infected" the jury. The Supreme Court has held on a number of occasions that the absence of "isolatable prejudice" is not a "prerequisite to reversal" when the Government's participation in generating or disseminating adverse publicity "involves such a probability that prejudice will result that it is deemed inherently lacking in due process." Estes v. Texas, 381 U.S. 532, 542, 543-44 (1965) (emphasis added). See also, Sheppard v. Maxwell, supra, 384 U.S. at 351-52; Irvin v. Dowd, supra, 366 U.S. at 725; Marshall v. United States, supra, 360 U.S. at 312. Moreover, this Court has acknowledged in dictum that "the Government's conduct in generating publicity" might demand "the drastic sanction" of dismissing the indictment "in the interest of the particular defendant or for general therapeutic purposes, or for both." United States v. Grassia, 354 F.2d 27, 29 (2d Cir. 1965) vacated on other grounds, 390 U.S. 202 (1968) (emphasis added). Cf. United States v. McCord, — F.2d — (D.C. Cir. No. 73-2252) (Dec. 12, 1974).

In all prior cases, the courts have found, however, that the defendants had failed to show that the Government was in fact the source of illicit leaks or that the information purveyed by a Government official was not really likely to threaten the defendant's rights.* Of course, in the present situation the Government has formally admitted that

In each of these cases the defendants alleged Government sponsorship of pre-indictment publicity, and despite the extraordinary judicial reluctance to consider indictments tainted, the district judges inquired into the merits of the charges, stating that dismissal

could be ordered, if the charges were substantiated.

^{*} See United States v. Sweig, 316 F.Supp. 1148, 1153 (S.D. N.Y. 1970), aff'd 441 F. 2d 114 (2d Cir.), cert. denied, 403 U.S. 932 (1971); see also United States v. Hong Loi Cheng, 350 F.Supp. 67, 69 (S.D.N.Y. 1972); United States v. Archer, 355 F. Supp. 981, 989 (S.D.N.Y. 1972), rev'd on other grounds, 486 F.2d 670 (2d Cir. 1973); United States v. Mitchell, 372 F.Supp. 1239, 1248 (S.D. N.Y. 1973).

it is the source of the improper publicity, and the extrajudicial statement made was precisely the kind condemned by Local Rule 8, by the Justice Department regulations and by the other applicable standards for criminal prosecutions—a direct expression of belief that the defendants were guilty.

Chief Accountant Burton's conduct was forbidden by regulation and decisions that are designed not just to prevent actual prejudice to the accused but also to guard against even the risk of prejudice. The goal of the rules banning the dissemination of prejudicial information by Government officers about the merits of a pending criminal proceeding is to protect against a disclosure that creates a "reasonable likelihood" of prejudice (Local Rule 8) or that "tends to create dangers of prejudice" (28 C.F.R. § 50.2(b)). Even though not every release of prejudicial information will actually result in prejudice to the accused, that fortuitous lack of injury in no way excuses the deliberate creation of the risk of constitutional deprivation.

A requirement that the defendant show actual prejudice from the publication of such blatantly improper remarks by Government officials would be an admission that the courts' often expressed condemnation of such conduct need not be taken seriously. In a criminal case where the jurors have been admonished by the trial judge not to read any newspaper articles about the case, it would be naive to assume that many jurors would freely admit to disregarding the judge's instruction. It is, therefore, highly unlikely that a defendant who is the subject of such an article during the trial will ever be able to prove actual prejudice. Conduct such as that admitted by the SEC Chief Accountant therefore could continue undeterred.

No miscarriage of justice would result from imposition of the remedy of dismissal in this case. As we have discussed elsewhere, the proof of guilt was at most marginal, the defendants' lives are otherwise blameless, and the trial judge himself was convinced of the sincerity of their belief that they did nothing wrong. While we will never know whether the Government's deliberate violation of the fair trial-free press principles did tip the balance against the defendants, it at least created the grave risk of that injustice. Under all circumstances, therefore, the indictment in this case should be dismissed.

POINT VI

The District Court erred in denying the defendant's motion to dismiss Count II of the indictment for lack of proper venue.

Count II of the indictment charged appellants Natelli and Scansaroli and four other defendants with unlawfully making and causing to be made certain false and misleading statements in a proxy statement which "was required to be filed and was filed with the SEC," a violation of Section 32(a) of the Securities Exchange Act ("the Act") 15 U.S.C. § 78ff. The indictment alleged that the false statements were made in the Southern District of New York, where the indictment was returned. Prior to trial, appellants Natelli and Scansaroli jointly moved to dismiss Count II on the ground that venue for this offense properly lay only where the proxy statement had been filed, the District of Columbia. The court below denied the motion.

Section 27 of the Securities Exchange Act, 15 U.S.C. § 78aa, provides that criminal proceedings for violation of that Act are to be brought in a district where "any act or transaction constituting the violation occurred" (emphasis added). Here the critical act of filing the proxy statement containing the allegedly false statements occurred in the District of Columbia where appellant had his office and where NSMC maintained its official headquarters. Appellant was therefore not properly subjected to trial in the Southern District of New York.

The sole violation upon which appellant Natelli was tried and convicted was the making or causing to be made of materially false statements in a proxy statement required to be and filed with the SEC in Washington, D.C. Whatever might be the proper venue for the prosecution of allegedly false or fraudulent statements made to shareholders or investors under other criminal provisions designed to protect those persons, or whatever might be the venue in a mail fraud case there were no such charges here. Thus the Court here must focus on the elements of the offense with which appellant was actually charged in determining the proper venue. Under the Section 32(a) offense here at issue, the violation occurred, if at all, only when the allegedly misleading proxy materials were communicated to the Commission by delivery to its Washington offices. Only then and only there was a false statement "made" for purposes of the criminal provision in question.

Only two of the seven reported decisions regarding venue for criminal false statement violations of the federal securities laws are pertinent to the Section 32 offense involved here.* In the most recent of these, *United States*

^{*}Four of the five remaining decisions pertained exclusively to mail fraud offenses under 18 U.S.C. § 1341 and Section 17(a) of the 1933 Act, 15 U.S.C. 77(a): United States v. Williams, 424 F.2d 353 (5th Cir. 1970); Gates v. United States, 122 F.2d 571 (10th Cir. 1941); United States v. Hughes, 195 F.Supp. 795 (S.D.N.Y. 1061); United States v. Monjar, 47 F.Supp. 421 (D.Del. 1942), aff'd 147 F.2d 916 (3d Cir.), cert. denied, 325 U.S. 859 (1945). Accordingly, venue was determined with reference to the special mail fraud provisions of 18 U.S.C. § 3237. Since the only evidence in the present record regarding the mode of filing is that the proxy statement here at issue was received at the SEC's Washington office (GX 25), none of those discussions have relevance here. In the fifth decision United States v. Cashin, 281 F.2d 669 (2d Cir. 1960), the court's opinion was again confined exclusively to offenses not pertinent here, § 17(a) of the 1933 Act and § 14 of the 1934 Act. While the defendants there had additionally been charged with a false statement violation of § 32 of the 1934 Act, the court considered that matter moot on the venue issue, since the defendants had moved to have the case transferred out of the filing jurisdiction and the government equiesced in the motion. 281 F.2d at 672 n.5.

v. Greisa, 481 F.2d 276 (2d Cir. 1973), a majority of this Court declined to engage in interlocutory review of a pretrial venue determination regarding false statement violations of Section 32 of the 1934 Act in conjunction with annual reports and related documents filed with the SEC under Sections 12 and 13 of the Act, 15 U.S.C. §§ 781, 78m. Judge Timbers in a separate opinion, however, addressed the venue issue on its merits. Concluding that the trial judge was in error in finding venue proper in the jurisdiction where certain of the false statements were allegedly prepared, Judge Timbers expressly stated that a false statement can be said to have occurred only in the jurisdiction (or jurisdictions) in which the statement was subsequently filed:

"The false filing counts (Counts 63-65) charge certain defendants, including Clark, with filing a false listing application and false annual reports of Four Seasons with the American Stock Exchange and the Securities and Exchange Commission in violation of 15 U.S.C. §§ 781 and 78m (1970). Venue with respect to those counts can be laid only 'in the district wherein any act or transaction constituting the violation occurred.' 15 U.S.C. § 78aa (1970). The false documents having been filed in New York City and Washington, D.C.—not in Oklahoma—venue would be proper only in the Southern District of New York or the District of Columbia, not in the Western District of Oklahoma. See Travis v. United States, 364 U.S. 631, 636 (1961)." 481 F.2d at 289.

In the present case the proxy statement was filed *only* in the District of Columbia, and no filings took place in the Southern District of New York.

In the other pertinent case, *United States* v. *Pope*, 189 F.Supp. 12 (S.D.N.Y. 1960), Judge Weinfeld reached a contrary result regarding a venue for a false statement prosecution under Section 24 of the 1933 Act in conjunction with a registration statement filed with the SEC.

While acknowledging that filing with the SEC was a necessary element of the Section 24 offenses there alleged, he concluded that venue could alternatively be justified in the Southern District under either the "continuing offense" approach of 18 U.S.C. § 3237 or the principles applicable to accessorial conduct. 189 F.Supp. at 23-24. The principal decision on which Judge Weinfeld relied for the first ground, however-the Tenth Circuit's decision in Travis v. United States, 247 F.2d 130 (10th Cir. 1957)—was shortly thereafter reversed by the Supreme Court on that very point. Travis v. United States, 364 U.S. 631 (1961). Judge Weinfeld's reliance alternatively on principles governing the venue of accessorial conduct cannot apply here, when the case was not submitted to the jury on that theory. See United States v. Walden, 464 F.2d 1015, 1019-1020 (4th Cir. 1972); United States v. Sweig, 316 F. Supp. 1148 (S.D.N.Y. 1970).

Although there are only a few reported decisions dealing with venue for false statements filed with the SEC under the federal securities laws, a number of decisions have discussed the venue question under analogous federal statutes. Principal among these is the Supreme Court's decision in Travis v. United States, supra, 364 U.S. 631. In that case, the defendant was tried for violating the False Statements Act, 18 U.S.C. § 1001, which provides that, "Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully * * * makes any false, fictitious, or fraudulent statements or representations * * " is guilty of a crime. The particular false statement at issue was the defendant's denial in an affidavit that he had Commuist affiliations. The affidavit had been prepared and sworn to in Colorado, and filed with the National Labor Relations Board in Washington, D.C. The "key statutory verbs" under 18 U.S.C. § 1001 are virtually the same as they are under Section 32 of the Securities Exchange Act-the "making of a false statement" in a document submitted to a federal agency—and the Court held in Travis that venue did not properly lie where the false statement had been prepared, written, and mailed. Instead, the Court reasoned that no offense was committed until these statements had actually been filed with the NLRB and thus communicated—"made"—to the agency. Venue was accordingly held proper only in the district in which the document was filed. 362 U.S. at 636-637.

In reaching this result, the Court was careful to point out that it was not dealing with a criminal statute which itself independently required that the document containing the false statement be submitted, and for this reason the "continuing offense" theory was held inapplicable.* Unlike, for example, those provisions of the U.S. Code which require the filing of federal tax returns, the statute at issue in Travis only made the filing of the non-Communist affidavit a prerequisite for the subsequent conduct of others, and the failure to prepare and file the document was not itself an offense. In the Travis context, the resort to the processes of the NLRB was conditioned on having a non-Communist affidavit on file. The present case is on all fours, since the submission of a proxy statement to the SEC is required only indirectly: unless such a statement is on file, proxies may not lawfully be solicited. Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a).

The holding of *Travis* is therefore controlling here. The Supreme Court recognized in *Travis* that in interpreting a statutory scheme of the type also involved here, the element of "filing" is a discrete event, not a continuing process. In such a context, the core criminal context of "making" the false statement occurs—both for purposes

^{*&}quot;Section 9(h) of the National Labor Relations Act, with which we are concerned, did not require union officers to file non-Communist affidavits. If it had, the whole process of filing, including the use of the mails, might logically be construed to constitute the offense. But this statutory design is different." (emphasis added) 364 U.S. at 635.

of criminal liability and for venue—only when and where the document is filed.*

It is of no avail to the Government that certain preparatory acts leading up to the ultimate filing in Washington may have occurred in the Southern District of New York, including appellant's spending several hours in Manhattan reviewing proofs of one of the various drafts being printed there some six weeks before the proxy was filed. While this Court held in United States v. Bozza, 365 F.2d 206, 220-222 (2d Cir. 1966) that venue is proper in the jurisdiction in which a defendant's accessorial acts occurred, the defendant in that case had been charged solely as an accessory. When a defendant such as Natelli is charged as a principal, as is the case here, the law is otherwise and the government cannot prosecute the defendant "where the preparations took place." United States v. Sweig, 316 F.Supp. 1148, 1160-61 (S.D.N.Y. 1970); United States v. Walden, 464 F.2d 1015, 1019-1020 (4th Cir. 1972).

^{*} Cases sustaining venue for false statement prosecutions in districts other than where the documents containing those statements were filed can be reconciled with Travis if certain distinctions, not applicable here, are kept in mind. Thus, where criminal statutes do affirmatively require the filing of documents and those documents contain false statements, some lower federal courts both before and after Travis have held that such violations are "continuing offenses" within the meaning of 18 U.S.C. § 3237. These decisions have been principally in the federal tax area. See, e.g., United States v. Slutsky, 487 F.2d 832, 839 (2d Cir. 1973), cert. denied, 94 S.Ct. 1937 (1974); United States v. Gross, 276 F.2d 816 (2d Cir.), cert. denied, 363 U.S. 831 (1960); Newton v. United States, 162 F.2d 795 (4th Cir. 1947), cert. denied, 333 U.S. 848 (1948). In other cases where the filing was effectuated through the mails, some courts have relied upon the second paragraph of 18 U.S.C. § 3237(a), which declares that any offense involving the use of the mails can be prosecuted "in any district from, through, or into which such * * * mail matter moves," to sustain venue in the jurisdiction where the mailing occurred. See, e.g., Imperial Meat Co. v. United States, 316 F.2d 435 (10th Cir.), cert. denied, 375 U.S. 820 (1963); United States v. Ruehrup, 332 F.2d 641 (7th Cir.), cert. denied, 379 U.S. 904 (1964). See also this Court's decision in United States v. Miller, 246 F.2d 486 (2d Cir.), cert. denied, 355 U.S. 905 (1957). Here the Government offered no evidence in the present record to indicate that the filing was made other than by personal delivery to the SEC's Washington offices.

Thus, in *Bozza*, the conviction of co-defendant DeLutro was dismissed and the indictment ordered dismissed for lack of venue when the evidence showed that, although he had performed preparatory acts in the district of trial, he participated as a principal in the commission of the offenses in another district. 365 F.2d at 220-221. *Cf.*, *United States* v. *Taller*, 394 F.2d 435, 437-38 (2d Cir.), cert. denied, 393 U.S. 839 (1968).*

As this Court has held, "venue . . . is an essential part of the Government's case. Without it, there can be no conviction." United States v. Gross, supra, 276 F.2d at 819. Venue of the instant charges against appellant Natelli as a principal was proper only in the District of Columbia. Since the court failed to charge or explain any theory under which appellant's acts might support venue in the Southern District of New York, appellant is entitled now to a judgment of acquittal. United States v. Provoo, 215 F.2d 531, 537 (2d Cir. 1954); United States v. Jones, 174 F.2d 746, 748 (7th Cir. 1949).

Conclusion

In addition to the arguments made above, appellant Natelli adopts the arguments set forth in the brief of appellant Sanscaroli at Points II, III and IV.

We submit that because of the errors committed, taken either singly or in concert, the conviction of Mr. Natelli should be reversed. While some of the errors we cite relate only to one of the two specifications of material falsity set forth in the indictment, a finding of error in the submission of either specification requires reversal of the conviction, since it cannot be determined which specification provided the basis for the jury's verdict. Leary v. United

^{*}Since the court expressly refused to explain the concept of aiding and abetting to the jury (Tr. 2387) it is impossible now to imply a finding of venue on this theory. *United States* v. *Gillette*, 189 F.2d 449, 452 (2d Cir.), cert. denied, 342 U.S. 827 (1951). See also, *United States* v. *Byrd*, 352 F.2d 570, 575-76 (2d Cir. 1975).

States, 395 U.S. 35 (1969); United States v. Adcock, 447 F.2d 1337 (2d Cir.), cert. denied, 404 U.S. 939 (1971).

We submit that the evidence offered by the Government was not sufficient to support the conviction. We further submit that the appropriate disposition in this case is a dismissal of the indictment pursuant to this Court's power under 28 U.S.C. § 2106. The events on which the indictment was concerned occurred in 1969, some five years prior to the trial. The testimony of the witnesses, both for the prosecution and the defense, was obviously affected by this passage of time. There is nothing to indicate that given another opportunity, the prosecution could make a better showing on remand. Rather, in view of the passage of time, the probabilities are directly to the contrary. In such circumstances, it would not be in the interests of justice to require another trial ,and the matter should be remanded to the District Court with instructions to enter a judgment dismissing the indictment. See, e.g., Yates v. United States, 354 U.S. 298 (1957); United States v. Jacobson, 325 F.2d 409 (2d Cir. 1963), aff'd 380 U.S. 246 (1965); United States v. Silverman, 248 F.2d 671, 686-687 (2d Cir. 1957), cert. denied, 355 U.S. 942 (1958).

Respectfully submitted,

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